United States General Accounting Office
President's Council on Integrity and Efficiency

GAO/PCIE

Financial Audit Manual

Exposure Draft

Volume 1

GAO-01-281G

[This page intentionally left blank]

CONTENTS

[This page intentionally left blank]

CONTENTS

100 INTRODUCTION

200 PLANNING PHASE

210 Overview
220 Understand the Entity's Operations
225 Perform Preliminary Analytical Procedures
230 Determine Planning, Design, and Test Materiality
235 Identify Significant Line Items, Accounts, Assertions, and RSSI
240 Identify Significant Cycles, Accounting Applications, and Financial Management Systems
245 Identify Significant Provisions of Laws and Regulations
250 Identify Relevant Budget Restrictions
260 Identify Risk Factors
270 Determine Likelihood of Effective Information System Controls
275 Identify Relevant Operations Controls to Evaluate and Test
280 Plan Other Audit Procedures
- Inquiries of Attorneys
- Management Representations
- Related Party Transactions
- Sensitive Payments
- Reaching an Understanding with Management and Requesters
- Other Audit Requirements

285 Plan Locations to Visit
290 Documentation

Appendixes to Section 200:

295 A Potential Inherent Risk Conditions
295 B Potential Control Environment, Risk Assessment, Communication, and Monitoring Weaknesses
295 C An Approach for Multiple-Location Audits
295 D Interim Testing
295 E Effect of Risk on Extent of Audit Procedures
295 F Types of Information System Controls
295 G Budget Controls
295 H Laws Identified in OMB Audit Guidance
295 I Examples of Auditor Responses to Fraud Risk Factors
295 J Steps in Assessing Information System Controls

300 INTERNAL CONTROL PHASE

310 Overview
320 Understand Information Systems
330 Identify Control Objectives
340 Identify and Understand Relevant Control Activities
350 Determine the Nature, Timing, and Extent of Control Tests and of Tests for Systems' Compliance with FFMIA Requirements
360 Perform Nonsampling Control Tests and Tests for Systems' Compliance with FFMIA Requirements
370 Assess Controls on a Preliminary Basis
380 Other Considerations
390 Documentation

Appendixes to Section 300:

395 A Typical Relationships of Accounting Applications to Line Items/Accounts
395 B Financial Statement Assertions and Potential Misstatements
395 C Typical Control Activities
395 D Selected Statutes Relevant to Budget Execution
395 E Budget Execution Process
395 F Budget Control Objectives
395 F Sup Budget Control Objectives—Federal Credit Reform Act Supplement
395 G Rotation Testing of Controls
395 H Specific Control Evaluation Worksheet
395 I Account Risk Analysis Form

400 TESTING PHASE

410 Overview
420 Consider the Nature, Timing, and Extent of Tests
430 Design Efficient Tests
440 Perform Tests and Evaluate Results
450 Sampling Control Tests
460 Compliance Tests
470 Substantive Tests—Overview
475 Substantive Analytical Procedures
480 Substantive Detail Tests
490 Documentation

Appendixes to Section 400:

495 A Determining Whether Substantive Analytical Procedures Will Be Efficient and Effective
495 B Example Procedures for Tests of Budget Information
495 C Guidance for Interim Testing
495 D Example of Audit Matrix with Statistical Risk Factors
495 E Sampling
495 F Manually Selecting a Dollar Unit Sampling

500 REPORTING PHASE

510 Overview
520 Perform Overall Analytical Procedures
530 Determine Adequacy of Audit Procedures and Audit Scope
540 Evaluate Misstatements
550 Conclude Other Audit Procedures
- Inquiries of Attorneys
- Subsequent Events
- Management Representations
- Related Party Transactions

560 Determine Conformity With Generally Accepted Accounting Principles
570 Determine Compliance with GAO/PCIE *Financial Audit Manual*
580 Draft Reports
- Financial Statements
- Internal Control
- Compliance with Laws and Regulations
- Financial Management Systems
- Other Information in the Accountability Report

590 Documentation

Appendixes to Section 500:

595 A Example Auditor's Report—Unqualified
595 B Suggested Modifications to Auditor's Report
595 C Example Summary of Possible Adjustments
595 D Example Summary of Unadjusted Misstatements

APPENDIXES

A Consultations
B Instances Where the Auditor "Must" Comply with the FAM

GLOSSARY

ABBREVIATIONS

INDEX

SECTION 100

Introduction

Figure 100.1: 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, assertions, and RSSI	235
• Identify significant cycles, accounting applications, and financial management systems	240
• Identify significant provisions of laws and regulations	245
• Identify relevant budget restrictions	250
• Assess risk factors	260
• Determine likelihood of effective information system 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 information systems	320
• Identify control objectives	330
• Identify and understand relevant control activities	340
• Determine the nature, timing, and extent of control tests and of tests for systems' compliance with FFMIA requirements	350
• Perform nonsampling control tests and tests for systems' compliance with FFMIA requirements	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 generally accepted accounting principles	560
• Determine compliance with GAO/PCIE *Financial Audit Manual*	570
• Draft reports	580

100 – INTRODUCTION

.01 This introduction provides an overview of the methodology of the General Accounting Office (GAO) and the President's Council on Integrity and Efficiency (PCIE) for performing financial statement audits of federal entities, describes how the methodology relates to relevant auditing and attestation standards and Office of Management and Budget (OMB) guidance, and outlines key issues to be considered in using the methodology.

OVERVIEW OF THE 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 control and underlying financial management systems. To achieve these purposes, the approach to federal 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 control and, for Chief Financial Officers (CFO) Act Agencies and components designated by OMB, whether financial management systems substantially comply with the requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA): federal financial management systems requirements, applicable federal accounting standards,[1] and the *U.S. Government Standard General Ledger* (SGL) at the transaction level.[2]

---

[1] In October 1999 the American Institute of Certified Public Accountants (AICPA) recognized the Federal Accounting Standards Advisory Board (FASAB) as the accounting standards-setting body for federal government entities under Rule 203 of the AICPA's Code of Professional Conduct. Thus, FASAB standards are recognized as generally accepted accounting principles (GAAP) for federal entities. FASAB standards (Statement of Federal Financial Accounting Standards No. 8, paragraph .40) allow government corporations and certain other federal entities to report using GAAP issued by the Financial Accounting Standards Board (FASB).

[2] Although the results of FFMIA testing are reported as part of the compliance section of the auditor's report, testing for FFMIA is most efficiently

- Test the significant assertions related to the financial statements and test compliance with laws and regulations.

- Report the results of audit procedures performed.

These phases are illustrated in figure 100.1 and are summarized below. [3]

Planning Phase

.03 Although 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, accounting applications, and financial management systems; important budget restrictions, significant provisions of laws and regulations; and relevant controls over the entity's operations;

- determining the likelihood of effective information systems (IS) controls;

- performing a preliminary risk assessment to identify high-risk areas, including considering the risk of fraud; and

- planning entity field locations to visit.

accomplished, for the most part, as part of the work done in understanding agency systems in the Internal Control phase of the audit.

[3] The methodology presented is for performance of a financial statement audit. If the auditor is to use the work of another auditor, see FAM section 650.

Internal Control Phase

.04 This phase entails evaluating and testing internal control to support the auditor's conclusions about the achievement of the following internal control objectives:

- Reliability of financial reporting—transactions are properly recorded, processed, and summarized to permit the preparation of the principal statements and required supplementary stewardship information (RSSI) in accordance with generally accepted accounting principles (GAAP), and assets are safeguarded against loss from unauthorized acquisition, use, or disposition.

- Compliance with applicable laws and regulations—transactions are executed in accordance with (a) laws governing the use of budget authority and other laws and regulations that could have a direct and material effect on the principal statements or RSSI and (b) any other laws, regulations, and governmentwide policies identified by OMB in its audit guidance.

OMB audit guidance requires the auditor to test controls that have been properly designed to achieve these objectives and placed in operation, to support a low assessed level of control risk. This may be enough testing to give an opinion on internal control. GAO audits should be designed to give an opinion on internal control.[4] If the auditor does not give an opinion, generally accepted government auditing standards (GAGAS) require the report to state whether tests were sufficient to give an opinion.

.05 OMB's audit guidance includes a third objective of internal control, related to performance measures. The auditor is required to understand the components of internal control relating to the existence and completeness assertions and to report on internal controls that have not been properly designed and placed in operation, rather than to test controls.

[4] AICPA attestation standards allow the auditor to give an opinion on internal control or on management's assertion about the effectiveness of internal control (except that if material weaknesses are present, the opinion must be on internal control, not management's assertion). The example report in this manual assumes the opinion will be on internal control directly.

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

.07 To evaluate internal control, the auditor identifies and understands the relevant controls and tests their effectiveness. Where controls are considered to be effective, the extent of substantive testing can be reduced.

.08 The methodology includes guidance on

- assessing specific levels of control risk,
- selecting controls to test,
- determining the effectiveness of IS controls, and
- testing controls, including coordinating control tests with the testing phase.

.09 Also, during the internal control phase, for CFO Act agencies and their components identified in OMB's audit guidance, the auditor should understand the entity's significant financial management systems and test their compliance with FFMIA requirements.

Testing Phase

.10 The objectives of this phase are to (1) obtain reasonable assurance about whether the financial 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 control through control tests that are coordinated with other tests.

.11 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 multipurpose tests that use a common sample to test several different controls and specific accounts or transactions.

Reporting Phase

.12 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 (1) financial statements (also called Principal Statements) and other information (management's discussion and analysis [MD&A] or the overview, RSSI, other required supplementary information, and other accompanying information), (2) internal control, and (3) compliance with laws and regulations and whether the financial management systems substantially comply with FFMIA requirements. To assist in this process, the methodology includes guidance on forming opinions on the principal statements and conclusions on internal control, as well as how to determine which findings should be reported. Also included is an example report designed to be understandable to the reader.

RELATIONSHIP TO APPLICABLE STANDARDS

.13 The following section describes the relationship of this audit methodology to applicable auditing standards, OMB guidance, and other 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

.14 This manual provides a framework for performing financial statement audits in accordance with *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 (AICPA); and OMB's audit guidance.

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

- **effective audits** by considering compliance with the CFO Act, FFMIA, 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.

.16 The manual supplements GAGAS and OMB's audit guidance. References are made to Statements on Auditing Standards (preceded by the prefix "AU") and Statements on Standards for Attestation Engagements (SSAE) (preceded by the prefix "AT") of the *Codification of Statements on Auditing Standards*, issued by the AICPA, that are incorporated into GAGAS.

Audit Requirements Beyond the "Yellow Book"

.17 In addition to meeting GAGAS requirements, audits of federal entities must be designed to achieve the following objectives described in OMB's audit guidance:

- responsibility for performing sufficient tests of internal controls that have been properly designed and placed in operation, to support a low assessed level of control risk;
- expansion of the nature of controls that are evaluated and tested to include controls related to RSSI, budget execution, and compliance with laws and regulations;

- responsibility to understand the components of internal control relating to the existence and completeness assertions relevant to the performance measures included in the MD&A, in order to report on controls that have not been properly designed and placed in operation;

- responsibility to consider the entity's process for complying with the Federal Managers' Financial Integrity Act (FMFIA);

- responsibility to test for compliance with laws, regulations, and governmentwide policies identified in OMB's audit guidance at CFO Act agencies (regardless of their materiality to the audit);

- responsibility to perform sufficient tests at CFO Act agencies and components identified by OMB to report whether the entity's financial management systems substantially comply with FFMIA requirements; and

- responsibility to consider conformity of the MD&A, RSSI, required supplementary information, and other accompanying information with FASAB requirements and OMB guidance.

.18 To help achieve the goals of the CFO Act, GAO audits should be designed to achieve the following objectives,[5] in addition to those described in OMB's audit guidance:

- Provide an opinion on internal control.

- 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 activities are properly designed and placed in operation, even if a poor control environment precludes their effectiveness.

[5] The manual refers specifically to objectives of GAO audits in various sections. Such objectives are optional for other audit organizations.

- Understand the components of internal control relating to the valuation assertion relevant to performance measures reported in the MD&A in order to report on controls that have not been properly designed and placed in operation.

Auditing Standards and Other Policies Not Addressed in the Manual

.19 This manual was designed to supplement financial audit and other policies and procedures adopted by GAO and Inspectors General (IGs). As such, it was not intended to address in detail all requirements. For example, report processing is not addressed.

.20 Updates to this manual that include additional audit guidance and practice aids, such as checklists and audit programs, will be issued from time to time. GAO will be responsible for preparing the updates, in consultation with the PCIE audit committee.

KEY IMPLEMENTATION ISSUES

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

- audit objectives,
- exercise of professional judgment,
- references to positions,
- use of IS auditors,
- compliance with policies and procedures in the manual,
- use of technical terms, and
- reference to GAO/PCIE *Financial Audit Manual* (FAM).

Audit Objectives

.22 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. The manual generally assumes that the objective of the audit is to render an opinion on the current year financial statements, a report on internal control, and a report on compliance. Where these are not the objectives, the auditor should use judgment in applying the guidance. In some circumstances, the auditor will expect to issue a disclaimer on the

current year financial statements (because of scope limitations). In these circumstances, the auditor may develop a multiyear plan to be able to render an opinion when the financial statements are expected to become auditable.

Exercise of Professional Judgment

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

.24 Many aspects of the audit require technical judgments. The auditor should ensure a person with adequate technical expertise is available, especially in the following areas:

- quantifying planning materiality, design materiality, and test materiality and using materiality as one consideration in determining the extent of testing (see section 230);

- specifying a minimum level of substantive assurance based on the assessed combined risk, analytical procedures, and detail tests (see sections 470, 480, and 495 D);

- documenting whether selections are samples (intended to be representative and projected to populations) or nonrepresentative selections that are not projectible (see section 480);

- using sampling methods, such as dollar-unit sampling, classical variables estimation sampling, or classical probability proportional to size (PPS) sampling, for substantive or multipurpose testing (including nonstatistical sampling) (see section 480);

- using sampling for control testing, other than attribute sampling using the tables in section 450 to determine sample size when not performing a multipurpose test;

- using sampling for compliance testing of laws and regulations, other than attribute sampling using the tables in section 460 to determine sample size when not performing a multipurpose test; and

- placing complete or partial reliance on analytical procedures, using test materiality to calculate the limit. The limit is the amount of difference between the expected and recorded amounts that can be accepted without further investigation (see section 475).

References to Positions

.25 Various sections of this manual make reference to consultation with audit management and/or persons with technical expertise to obtain approval or additional guidance. Key consultations should be documented in the audit workpapers. Each audit organization should document, in the workpapers or its audit policy manual, the specific positions of persons who will perform these functions. An IG using a firm to perform an audit in accordance with this manual should clarify and document the positions of the persons the firm should consult in various circumstances.

- The **Assistant Director** is the top person responsible for the day-to-day conduct of the audit.

- The **Audit Director** is the senior manager responsible for the technical quality of the financial statement audit, reporting to the Assistant Inspector General for Audit or, at GAO, to the Managing Director.

- The **Reviewer** is the senior manager responsible for the quality of the auditor's reports, reporting to the Assistant Inspector General for Audit (or higher position) or, at GAO, is the Managing Director. The Reviewer may consult with others.

- The **Statistician** is the person the auditor consults for technical expertise in areas such as audit sampling, audit sample evaluation, and selecting entity field locations to visit.

- The **Data Extraction Specialist** is the person with technical expertise in extracting data from agency records.

- The **Technical Accounting and Auditing Expert** is the senior manager reporting to the Assistant Inspector General for Audit or higher or, at GAO, is the Chief Accountant. The Technical Accounting Expert advises on accounting and auditing professional matters and related national issues. The Technical Accounting Expert reviews reports on

financial statements and reports that contain opinions on financial information.

- The **Office of General Counsel** (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 **Special Investigator Unit** investigates specific allegations involving conflict-of-interest and ethics matters, contract and procurement irregularities, official misconduct and abuse, and fraud in federal programs or activities. In the offices of the IGs this is the investigation unit; at GAO, it is Special Investigations. The Special Investigator Unit provides assistance to the auditor by (1) informing the auditor of relevant pending or completed investigations of the entity and (2) investigating possible instances of federal fraud, waste, and abuse.

Use of Information Systems Auditors

.26 The manual also refers to information systems (IS) auditors. IS auditors should possess sufficient technical knowledge and experience to understand the relevant concepts discussed in the manual and to apply them to the audit. While the auditor is ultimately responsible for assessing inherent and control risk, assessing the effectiveness of IS controls requires a person with IS audit technical skills. The IS auditor, for example, may be needed to determine the effect of computer processing on the audit, to understand and test the effectiveness of the controls, or to design and perform audit procedures. Further, specialized technical skills generally are needed in situations where, (1) the entity's systems, automated controls, or the manner in which they are used in conducting the entity's business are complex, (2) significant changes have been made to existing systems or new systems implemented, (3) data are extensively shared among systems, (4) the entity participates in electronic commerce, (5) the entity uses emerging technologies, or (6) significant audit evidence is available only in electronic form. Appendix V of GAO's *Federal Information System Controls Audit Manual* (FISCAM) contains examples of knowledge, skills, and abilities needed by IS auditors. Certain financial auditors also may possess IS audit technical skills. In some cases, the auditor may require outside consultants to provide these skills.

Compliance With Policies and Procedures in the Manual

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

- **Must:** Compliance with this policy or procedure is mandatory unless an exception is approved in writing by the Reviewer,[6] 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. The Assistant Director should approve this memorandum and copies should be sent to the Audit Director and the Reviewer.

- **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

.28 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.

Reference to GAO/PCIE *Financial Audit Manual*

.29 When cited in workpapers, correspondence, or other communication, the letters "FAM" should precede section or paragraph numbers from this manual. For example, this paragraph should be referred to as FAM 100.29.

[6] Capitalized positions are described in paragraph 100.25.

SECTION 200

Planning Phase

Figure 200.1: 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, assertions and RSSI	235
• Identify significant cycles, accounting applications, and financial management systems	240
• Identify significant provisions of laws and regulations	245
• Identify relevant budget restrictions	250
• Assess risk factors	260
• Determine likelihood of effective information system 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 information systems	320
• Identify control objectives	330
• Identify and understand relevant control activities	340
• Determine the nature, timing, and extent of control tests and of tests for systems' compliance with FFMIA requirements	350
• Perform nonsampling control tests and tests for systems' compliance with FFMIA requirements	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 generally accepted accounting principles	560
• Determine compliance with GAO/PCIE *Financial Audit Manual*	570
• Draft reports	580

Planning Phase

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 Accountability Report (or annual financial statement). The nature, extent, and timing of planning varies with, for example, 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 directly affect planning the substantive audit procedures. Also, the results of control and substantive tests may require changes in the planned audit approach.

[This page intentionally left blank.]

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, fraud risks, control environment, risk assessment, communications, and monitoring. 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) information system structure, (6) qualifications and competence of key personnel, and (7) turnover of key personnel.

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

- generally accepted accounting principles, including whether the entity is likely to be in compliance;
- changes in GAAP that affect the entity; and

- whether entity management appears to follow aggressive or conservative accounting policies.

.06 The auditor also should consider whether the entity will report any required supplementary stewardship information (RSSI). This includes stewardship property, plant, and equipment (PP&E) (heritage assets, national defense assets, and stewardship land), stewardship investments (nonfederal physical property, human capital, and research and development), social insurance, and risk-assumed information. RSSI and deferred maintenance, which is considered required supplementary information, should be designated "unaudited."

.07 The auditor should develop and document a high-level understanding of the entity's use of information systems (IS) and how IS affect the generation of financial statement information, RSSI, and the data that support performance measures reported in the MD&A (overview) of the Accountability Report (CFO report). An IS auditor may assist the auditor in understanding the entity's use of IS. Appendix I of the GAO *Federal Information System Controls Manual* (FISCAM) can be used to document this understanding.

.08 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),
- others in the audit organization concerning other completed, planned or in-progress assignments,
- personnel in OGC,
- personnel in the Special Investigator Unit, and
- entity legal representatives.

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

- the entity's prior Accountability Reports;
- other financial information;
- FMFIA reports and supporting documentation;
- reports by management or the auditor about systems' substantial compliance with FFMIA requirements;
- 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, internet sites, and other publications.

[This page intentionally left blank.]

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.

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. Also, 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 identifying 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, fraud, and/or inherent risks.

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 (fraud) 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. Test materiality may be different for different line items or accounts.

.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 financial 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 580.35-.37.

- **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 financial 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 Audit Director should discuss the basis for the determination with the Reviewer. The planning materiality selected and method of determining planning materiality should be documented and approved by the Audit Director.

.08 The auditor should estimate planning materiality in relation to the element of the 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 use the low end of the range of estimated materiality 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 intragovernmental balances (such as funds with the U.S. Treasury, U.S. Treasury securities, and interentity 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 intragovernmental 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.[1]

[1] If the auditor uses software to calculate sample size, he or she should understand how the software considers expected misstatements. For example, if the auditor uses IDEA to calculate sample size when test materiality is lower than design materiality, because the auditor expects misstatements, the auditor should use design materiality in IDEA because he or she separately inputs the expected misstatement. See paragraph 480.27.

235 - IDENTIFY SIGNIFICANT LINE ITEMS, ACCOUNTS, ASSERTIONS, AND RSSI

.01 The auditor should identify significant line items and accounts in the financial statements and significant related financial statement assertions. The auditor should also identify significant RSSI.[1] 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. However, some line items and accounts with zero or unusual balances may warrant testing, especially with regard to the completeness assertion.

.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.

---

[1] The auditor is not required to opine on RSSI, but, per OMB audit guidance, internal control over RSSI should be tested the same as internal control over the financial statements.

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

.03 A line item or an account in the financial statements or RSSI 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 or RSSI 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. For example, a zero or unusually small balance account may have a high risk of material understatement.

- 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 a revenue 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.

[This page intentionally left blank.]

240 - IDENTIFY SIGNIFICANT CYCLES, ACCOUNTING APPLICATIONS, AND FINANCIAL MANAGEMENT SYSTEMS

.01 In the internal control phase, the auditor evaluates controls for each significant cycle and accounting application and determines whether significant financial management systems substantially comply with federal financial management systems requirements, federal accounting standards, and the SGL at the transaction level. 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 in the financial statements or significant RSSI. A financial management system generally consists of one or more accounting applications. If one or more of the accounting applications making up a financial management system are considered significant, then that financial management system generally should be considered significant for determining whether the system substantially complies with FFMIA requirements. The auditor may identify other cycles, accounting applications, or financial management systems 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 and into financial management systems by the entity. 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. Similarly, related accounting applications also comprise financial management systems.

.05 For each significant line item and account, the auditor should use the Account Risk Analysis form (ARA) (see section 395 I) or an equivalent workpaper 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). The Account Risk Analysis form provides a convenient way for documenting the specific risks of misstatement for significant line items for consideration in determining the nature, timing, and extent of audit procedures. If an equivalent workpaper is used, rather than the ARA, it should document the information discussed in section 395 I.

.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 or equivalent, 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 <u>cycle matrix</u> or equivalent document that links each of the entity's accounts (in the chart of accounts) to a cycle, an accounting application, and a financial statement or RSSI 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.

.08 Once the significant accounting applications are identified, the auditor determines which computer systems are involved in those applications. Those particular computer systems are then considered in assessing computer-related controls. The auditor should use the GAO *Federal Information System Controls Audit Manual* (FISCAM), or an equivalent methodology. See section 295 J for a flowchart of steps generally followed in assessing information system controls in a financial statement audit.

.09 If an equivalent methodology is used, the auditor should be satisfied that sufficient knowledge of the information system relevant to financial reporting has been obtained to understand the accounting processing from initiation of a transaction to its inclusion in the financial statements, including electronic means used to transmit, process, maintain, and access information (see AU 319.36). AU 319.44 requires documentation of the understanding. OMB audit guidance notes that the components of internal control include general and application controls and requires that, for controls that have been properly designed and placed in operation, the auditor shall perform sufficient tests to support a low assessed level of control risk. The FISCAM is designed to meet these requirements. If the auditor uses an equivalent methodology, he or she should document the basis for believing that the methodology is equivalent.

[This page intentionally left blank.]

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, as amended, requires the awarding entity to review certain financial information on awardees.

.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 an appendix of OMB's audit guidance and is included in section 295 H. The entity is expected to develop a list that, for CFO Act agencies and components listed in OMB audit guidance, should include laws and regulations in OMB audit guidance, whether or not they are material to the entity, because they have been determined to be

material to the consolidated financial statements of the United States Government. 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 exceeds planning materiality.

- **Procedural-based provisions:** The provision broadly affects all or a segment of the entity's operations that process 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 obligation, outlay, or borrowing restrictions),

- the method used to record such transactions (such as revenue recognition policies), or

- the nature and extent of information to be reported or disclosed in the 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 obligations or outlays and therefore have a direct effect on determining amounts in the financial statements. If a provision's effect on the financial statements is limited to contingent liabilities as a result of noncompliance (typically for fines, penalties, and interest), such a provision does not have a direct effect on determining financial statement amounts. 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 and 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 audit guidance.

.08 In considering regulations to test for compliance, the auditor should consider externally imposed requirements issued pursuant to the Administrative Procedures Act, which has a defined due process. This would include regulations in the *Code of Federal Regulations*, but would not include OMB circulars and bulletins. Such circulars and bulletins generally implement laws, and the provisions of the laws themselves could be considered for compliance testing. Internal policies, manuals, and directives may be the basis for internal controls, but are not regulations to consider for testing for compliance.

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; and
- the Federal Credit Reform Act of 1990.

.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 outlays ("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 or its programs (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.

260 - IDENTIFY RISK FACTORS

.01 The auditor's consideration of inherent risk, fraud risk, control environment, risk assessment, communication, and monitoring (parts of internal control) affects the nature, timing, and extent of substantive and control tests. This section describes (1) the impact of risk factors identified during this consideration on substantive and control tests, (2) the process for identifying these risk factors, and (3) the auditor's consideration of the entity's process for reporting under FMFIA (both for internal control (section 2 of FMFIA) and for financial management systems' conformance with system requirements (section 4 of FMFIA)) and for formulating the budget.

IMPACT ON SUBSTANTIVE TESTING

.02 AU 312 provides guidance on the consideration of audit risk and 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. Internal control consists of five components: (1) the control environment, (2) risk assessment, (3) monitoring, (4) information and communication, and (5) control activities (defined in paragraph 260.08 below). This section will discuss the first three of the components and communication and section 300 (Internal Control Phase) will discuss the information systems and control activities.

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

AU 316 (SAS 82) requires the auditor to consider **fraud risk**, which is a part of audit risk, making up a portion of inherent and control risk. Fraud risk consists of the risk of fraudulent financial reporting and the risk of misappropriation of assets that cause a material misstatement of the

financial statements. The auditor should specifically consider and document the risk of material misstatements of the financial statements due to fraud and keep in mind the consideration of fraud risk in designing audit procedures. Considering the risk of material fraud generally should be done concurrently with the consideration of inherent and control risk, but it should be a separate conclusion. The auditor also should consider the risk of fraud throughout the audit. Section 290 includes documentation requirements for the consideration of fraud risk.

.03 Based on the level of audit risk and an assessment of the entity's inherent and control risk, including the consideration of fraud 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 may perform

- 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).[1] AU 350.48 uses 5 percent as the allowable audit risk in explaining the audit risk model (95 percent audit assurance). The audit organization should determine the level of assurance to use, which may vary between audits based on risk. GAO auditors should use 95 percent. In other words, the GAO auditor, in order to provide an opinion, should design the audit to achieve at least 95 percent audit assurance that the financial statements are not materially misstated (5 percent audit risk). Section 470 provides guidance to the auditor on how to combine (1) the assessment of inherent and control risk (including fraud risk) and (2) substantive tests to achieve the audit assurance required by the audit organization.

---

[1] Assurance is not the same as statistical confidence. Assurance is a combination of quantitative measurement and auditor judgment.

.05 The auditor may consider it necessary to achieve increased audit assurance if the entity is politically sensitive or if the Congress has expressed concerns about the entity's financial reporting. In this case, the level of audit assurance should be approved by the Reviewer.

RELATIONSHIP TO CONTROL ASSESSMENT

.06 Internal control, as identified in AU 319 (SAS 55 amended by SAS 78), is a process—effected by an entity's governing body, management, and other personnel—designed to provide reasonable assurance regarding the achievement of objectives in the following categories (OMB audit guidance expands the category definitions as noted):[2]

- Reliability of **financial reporting**—transactions are properly recorded, processed, and summarized to permit the preparation of the financial statements and RSSI in accordance with generally accepted accounting principles, and assets are safeguarded against loss from unauthorized acquisition, use, or disposition. (Note that **safeguarding** controls (see paragraphs 310.02-.04) are considered as part of financial reporting controls, although they are also operations controls.)

- **Compliance** with applicable laws and regulations—transactions are executed in accordance with (a) laws governing the use of budget authority and other laws and regulations that could have a direct and material effect on the financial statements or RSSI, and (b) any other laws, regulations, and governmentwide policies identified by OMB in its audit guidance. (Note that **budget** controls are part of financial reporting controls as they relate to the statements of budgetary resources and of financing, but that they are also part of compliance controls in that they are used to manage and control the use of appropriated funds and other forms of budget authority in accordance with applicable law. These controls are described in more detail in section 295 G.)

- Effectiveness and efficiency of **operations**. These controls include policies and procedures to carry out organizational objectives, such as planning, productivity, programmatic, quality, economy, efficiency, and

[2] See also GAO's *Standards for Internal Control in the Federal Government*, GAO/AIMD-00-21.3.1, November 1999.

effectiveness objectives. Management uses these controls to provide reasonable assurance that the entity (1) achieves its mission, (2) maintains quality standards, and (3) does what management directs it to do. (Note that **performance measures** controls (those designed to provide reasonable assurance about reliability of performance reporting—transactions and other data that support reported performance measures are properly recorded, processed, and summarized to permit the preparation of performance information in accordance with criteria stated by management) are included in operations controls.)

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

.08 The five components of internal control relate to objectives that an entity strives to achieve in each of the three categories: financial reporting (including safeguarding), compliance, and operations (including performance measures) controls. The components are defined in AU 319 as:

- The **control environment** sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure.

- **Risk assessment** is the entity's identification and analysis of relevant risks to achievement of its objectives, forming a basis for determining how the risks should be managed.

- **Information and communication** are the identification, capture, and exchange of information in a form and time frame that enable employees to carry out their responsibilities.

- **Monitoring** is a process that assesses the quality of internal control performance over time.

- **Control activities** are the policies and procedures that help ensure that management directives are carried out.

PROCESS FOR IDENTIFYING RISK FACTORS

.09 In the planning phase, the auditor should (1) identify conditions that significantly increase inherent, fraud, and control risk (based on identified control environment, risk assessment, communication, or monitoring weaknesses) and (2) conclude whether any identified control risks preclude the effectiveness of specific control activities in significant applications. The auditor identifies specific inherent risks, fraud risks, and control environment, risk assessment, communication, and monitoring 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-.51 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 (testing) 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 consideration requires the exercise of significant audit judgment, it should be performed by experienced audit team personnel.

.10 The auditor considers the implications of these risk factors on related operations controls. For example, inherent risk may be associated with a material liability for loan guarantees because it is subject to significant management judgment. In light of this inherent risk, the entity should have strong operations controls to monitor the entity's exposure to losses from loan guarantees. Potential 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 control weaknesses related to these risk factors should be identified and considered for further review, as discussed in section 275.

.11 Specific conditions that may indicate inherent or fraud risks or control environment, risk assessment, communication, or monitoring 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 risk factors after considering (1) his/her knowledge of the entity (obtained in previous steps in the planning phase); (2) the risk factors discussed in paragraphs 260.16-.51

and in sections 295 A and 295 B; and (3) other relevant factors. These risks and weaknesses and their impact on proposed audit procedures should be documented on the General Risk Analysis (GRA) or equivalent (see section 290). The auditor also should summarize and document any account-specific risks on the Account Risk Analysis (ARA) or equivalent (see sections 290 and 395 I).

.13 For each risk factor 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, (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 activity) may mitigate inherent risks associated with the completeness of cash receipts.

.14 The auditor also should document, in the GRA or equivalent, the overall effectiveness of the control environment, risk assessment, communication, and monitoring, including whether weaknesses preclude the effectiveness of specific control activities. The focus should be on management's <u>overall</u> attitude, awareness, and actions, rather than on specific conditions related to a control environment, risk assessment, communication, or monitoring factor. This assessment will be considered when determining the control risk associated with the entity.

.15 In assessing the control environment, risk assessment, communication, and monitoring, the auditor should specifically assess the quality of the entity's process for compliance with FMFIA (see paragraphs 260.43-.47) and should obtain an overall understanding of the budget formulation process (see paragraph 260.51).

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 fraud and sensitivity to changes in economic conditions. For example, student loan guarantee programs may be more susceptible to errors and fraud because of loans issued and serviced by third parties.

b. **Prior history of significant audit adjustments:** Significant audit adjustments identified in previous financial statement audits or other audits often identify 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 could then focus on

   - determining whether similar conditions continue to exist;
   - understanding management's response to such conditions (including implementation of controls), if any; and
   - assessing the nature and extent of the related inherent 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 fraud. For example, accounts involving subjective management judgments, such as loss allowances, are usually of higher risk than those involving objective determinations.

INFORMATION SYSTEMS (IS) EFFECTS ON INHERENT RISK

.17 Information systems (IS) do not affect the audit objectives for an account or a cycle. However, IS can introduce inherent risk factors not present in a manual accounting system. The auditor should (1) consider each of the following IS factors and (2) assess the overall impact of IS processing on inherent risk. The impact of these factors typically will be pervasive in nature. An IS auditor may assist the auditor in considering these factors and making this assessment. More detail on assessing IS controls in a financial statement audit is available in FISCAM, and a flowchart of the steps to follow is in section 295 J.

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

b. **Automatic processing:** The information system may automatically initiate transactions or perform processing functions. Evidence of these processing steps (and any related controls) may or may not be visible.

c. **Increased potential for undetected misstatements:** Computers use and store information in electronic form and require less human involvement in processing. This increases the potential for individuals to gain unauthorized access to sensitive information and to alter data without visible evidence. Due to the electronic form, changes to computer programs and data are not readily detectible. Also, users may be less likely to challenge the reliability of computer 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, invoice register (purchases summarized by day, month, and/or account), and general ledger postings from the invoice register. Some computerized 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 allow the auditor to effectively follow the audit trail. For example, one posting to the general ledger may result from the computer summarization of information from hundreds of locations. Without a hard copy audit trail, tracing transactions through computer processing may be extremely difficult.

e. **Nature of the hardware and software used in IS:** 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, Internet and 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 computerized 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.

FRAUD RISK FACTORS

.18 The auditor is concerned with fraud that causes a material misstatement of the financial statements. Fraud is distinguished from error in that the action causing the misstatement in fraud is intentional. Two types of misstatements are relevant in the auditor's consideration of fraud in a financial statement audit--misstatements arising from fraudulent financial reporting and misstatements arising from misappropriation of assets.

.19 Misstatements arising from fraudulent financial reporting are intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users. Misstatements arising from misappropriation of assets involve the theft of an entity's assets causing the financial statements not to be presented in conformity with GAAP.

.20 Both types of fraud usually involve a pressure or incentive to commit fraud and a perceived opportunity to do so. Many experts believe that fraud requires that both be present. Fraud may be concealed through falsified documentation. In a financial statement audit, the auditor does not have a responsibility to authenticate documents. Fraud also may involve collusion, which may cause evidence to appear persuasive when it is not. Although fraud is usually concealed, the presence of risk factors or other conditions may alert the auditor to a possibility of fraud. For example, documents may be missing or records out of balance. However, these conditions may be the result of errors rather than fraud.

Identification of Fraud Risk Factors

.21 The auditor should specifically consider and document the risk of material misstatement of the financial statements due to fraud and keep the consideration in mind in designing audit procedures. Considering the risk of material fraud generally should be done concurrently with the consideration of inherent and control risk, but it should result in specific identification of fraud risk factors that are present and the auditor's response to the factors. Although fraud risk factors do not necessarily suggest the presence of fraud, they have often been found in situations where fraud has occurred.

.22 As part of the consideration of fraud risk, in addition to obtaining representations about fraud risk in the management representation letter (see section 1001), the auditor should inquire of management (a) to obtain

management's understanding regarding the risk of fraud in the entity and (b) to learn whether management has knowledge of fraud perpetrated on or within the entity. In addition, if the entity has established a program to prevent, deter, and detect fraud, the auditor should ask the fraud prevention program managers whether the program has identified fraud risk factors.

.23 Inspectors general often report numerous cases of fraud. The auditor generally should obtain information about instances of fraud identified by the IG, ask the Special Investigator Unit to summarize how cases of reported fraud were committed, and ask management whether controls have been strengthened, to consider whether there is a risk of material fraud.

.24 Fraud risk factors that relate to misstatements arising from **fraudulent financial reporting** may be grouped in three categories as follows:

- **Industry conditions.** These factors involve the economic and regulatory environment in which the entity operates.

- **Operating characteristics and financial stability.** These factors pertain to the nature and complexity of the entity and its transactions, the entity's financial condition, and its profitability.

- **Management's characteristics and influence over the control environment.** These factors pertain to management's abilities, pressures, style, and attitude relating to internal control and the financial reporting process.

The first two of these categories contain factors that are also inherent risk factors mentioned in the earlier paragraphs of this section and the third category contains factors that are also control risk factors as discussed in subsequent paragraphs. Examples of fraud risk factors in each of these three categories in the federal government are included in sections 295 A and B.

.25 Fraud risk factors that relate to misstatements arising from **misappropriation of assets** may be grouped in two categories as follows:

- **Susceptibility of assets to misappropriation.** These factors pertain to the nature of an entity's assets and the degree to which they are subject to theft.

- **Controls.** These factors involve the lack of controls designed to prevent or detect misappropriations of assets.

Examples of fraud risk factors in the first of these two categories in the federal government are also included in section 295 A, and examples of the second category are included in section 295 B.

.26 It is not necessary for the auditor to search for indications of financial or other stress on employees that might make them likely to commit fraud. However, if the auditor becomes aware of such information, he or she should keep it in mind in considering the risk of material misstatement due to fraud. Other similar information would include disgruntled employees, anticipated layoffs, and known unusual changes in behavior or lifestyle of employees with access to assets susceptible to misappropriation.

The Auditor's Response to the Fraud Risk Consideration

.27 The risk of material misstatement due to fraud always exists to some degree. The auditor should decide whether the audit procedures already planned are sufficient to respond to the fraud risk factors found or whether there is a need to modify the planned audit procedures. If audit procedures need to be modified, the auditor should decide whether an overall response is appropriate or whether the response should be specific to a particular account balance, class of transactions, or assertion or whether both an overall and a specific response are called for. If it is not practicable, as part of a financial statement audit, to modify planned audit procedures sufficiently to address the fraud risk, the auditor should consider requesting assistance from the Special Investigator Unit. See section 290 for documentation requirements.

.28 The auditor may decide that an overall response covering one or more of the following is appropriate:

- **Professional skepticism**. Due professional care requires the exercise of professional skepticism--an attitude that includes a questioning mind and critical assessment of audit evidence. With an increased risk of material misstatement due to fraud, professional skepticism may cause the auditor to examine documentation of a different nature and greater extent in support of material transactions, or to corroborate management representations more extensively.

- **Assignment of audit personnel**. The qualifications and extent of supervision of personnel assigned on an audit generally should be commensurate with the level of fraud risk.

- **Accounting principles and policies**. With a greater risk of material misstatement due to fraud, the auditor may have a greater concern about whether management may apply accounting principles and policies in an inappropriate manner to create a material misstatement of the financial statements and may need to test more extensively.

- **Controls**. If increased fraud risk exists because of risk factors that have control implications, the auditor may have to assess control risk as high. However, understanding controls in this situation may be even more important than otherwise. The auditor generally should understand how controls (or lack thereof) relate to the fraud risk factors, while noting the extent of management's ability to override controls.

.29 Also in an overall response, the nature, timing, and extent of procedures related to certain accounts and assertions may be modified as follows:

- The **nature** may be changed to obtain more reliable evidence or further corroboration, such as from independent sources outside the entity. For example, physical observation of certain assets may become more important.

- The **timing** of substantive tests may be closer to or at year end.

- The **extent** of procedures may involve larger sample sizes or more extensive analytical procedures.

.30 The auditor may determine that a specific response is required due to the types of risk factors identified and the accounts and assertions that may be affected. Examples of specific responses are in section 295 I.

.31 The consideration of fraud risk is a cumulative process that should be ongoing throughout the audit. Fraud risk factors may be identified at any time during the audit. Also, other conditions may be identified during fieldwork that change or support a judgment regarding fraud risk, such as discrepancies in the accounting records, conflicting or missing evidential matter, or problematic or unusual relationships between management and

the auditor. Thus the auditor should continue to be aware of the risk of fraud, and at the conclusion of the audit, the auditor should consider whether the accumulated results of audit procedures and other observations affect the consideration of the risk of material misstatement due to fraud. (See section 540.)

CONTROL ENVIRONMENT FACTORS

.32 As discussed in AU 319 (SAS 55 amended by SAS 78), control environment risk factors incorporate management's attitude, awareness, and actions concerning the entity's control environment. These factors include

- integrity and ethical values,
- commitment to competence,
- management's philosophy and operating style,
- organizational structure,
- assignment of authority and responsibility,
- human resource policies and practices,
- management's control methods over budget formulation and execution,
- management's control methods over compliance with laws and regulations, and
- the functioning of oversight bodies (including congressional committees).

.33 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 activities. In making this determination, the auditor should consider the following factors and their effect on internal control. For each factor listed below, section 295 B lists conditions that may indicate control environment weaknesses.

a. **Integrity and ethical values:** Control effectiveness cannot rise above the integrity and ethical values of those who create, administer, and monitor the controls. Integrity and ethical values are essential elements of the control environment, affecting the design, administration, and monitoring of the other components. Integrity and ethical behavior result when the entity and its leaders have high ethical and behavioral standards and properly communicate them and reinforce them in practice. The standards include management's actions to remove or reduce incentives and temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts. The communication of

entity values and behavioral standards to personnel takes place through policy statements and codes of conduct and by example.

b. **Commitment to competence:** Competence is the knowledge and skills necessary to accomplish tasks required by an individual's job. Commitment to competence includes management's consideration of the competence levels for various jobs and the requisite skills and knowledge.

c. **Management's philosophy and operating style:** Management's philosophy and operating style encompass a broad range of beliefs, concepts, and attitudes. Such characteristics may include management's approach to taking and monitoring operational/program risks, attitudes and actions toward financial reporting, emphasis on meeting financial and operating goals, and management's attitude toward information processing, accounting, and personnel.

d. **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.

e. **Assignment of authority and responsibility:** An entity's policies or procedures for assigning authority for operating activities and for delegating responsibility affect the understanding of established reporting relationships and responsibilities. This factor includes policies relating to appropriate business practices, knowledge and experience of key personnel, and resource allocations. It also includes policies and communications to ensure that all personnel understand the entity's objectives, how they contribute to these objectives, and how and for what they will be held accountable.

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

g. **Management's control methods over budget formulation and execution**: Management's budget control methods affect the authorized use of appropriated funds. Budget formulation is discussed in more detail in paragraph 260.51, and controls over budget execution (budget controls) are addressed in more detail in section 300.

h. **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).

i. **The functioning of oversight groups:** An entity's oversight groups typically are responsible for overseeing both business activities and financial reporting. The effectiveness of an oversight group is influenced by its authority and its role in overseeing the entity's business activities. In the federal government, oversight groups are the Congress and the central agencies (OMB, Treasury, GSA, OPM, and GAO). Within agencies, senior management councils may also have a role in overseeing operations and programs.

RISK ASSESSMENT FACTORS

.34 Risk assessment is an entity's internal process for identifying, analyzing, and managing risks relevant to achieving the objectives of reliable financial reporting, safeguarding of assets, and compliance with budget and other laws and regulations. For example, risk assessment may address how the entity analyzes significant estimates recorded in the financial statements or how it considers the possibility of unrecorded transactions. Risks can arise due to both internal and external circumstances such as:

- changes in the operating or statutory environment,
- new personnel who may have a different focus on internal control,
- new or significantly changed information systems,
- rapid growth of programs which can strain controls,
- new technology which may change risks,
- new programs or activities which may introduce new control risks,
- restructurings or budget cutbacks which may include downsizing and changes in supervision and segregation of duties, or

- adoption of new accounting principles which may affect risks in preparing financial statements.

.35 The auditor should gain sufficient knowledge of the entity's risk assessment process to understand how management considers risks relevant to the objectives of financial reporting (including safeguarding), and compliance with budget and other laws and decides what actions to take. This understanding may include how management identifies risks, estimates their significance, assesses the likelihood of occurrence, and relates them to financial reporting.

COMMUNICATION FACTORS

.36 Communication involves providing an understanding of individual roles and responsibilities pertaining to internal control. It includes the extent to which personnel understand how their activities relate to the work of others and the means of reporting exceptions to an appropriate higher level within the entity. Open communication channels help ensure that exceptions are reported and acted on. Communication takes such forms as policy manuals, accounting and financial reporting manuals, and memoranda. Communication also may be electronic, oral, and through the actions of management in demonstrating acceptable behavior.

.37 The auditor should obtain sufficient knowledge of the means the entity uses to communicate roles and responsibilities for, and significant matters relating to financial reporting, safeguarding, and compliance with budget and other laws and regulations.

MONITORING FACTORS

.38 Monitoring is the process by which management assesses the quality of internal control performance over time. This may include ongoing activities, such as regular management and supervision, or communications from external parties, such as customer complaints or regulator comments that may indicate areas in need of improvement. This also may include separate evaluations, such as FMFIA work and IG or internal auditor work, or a combination of ongoing activities and separate evaluations.

.39 The auditor should gain sufficient knowledge of the major types of activities the entity uses to monitor internal control over financial reporting, including

safeguarding, and compliance with budget and other laws and regulations and how those activities are used to initiate corrective actions.

.40 The IG's office or internal audit is often an important part of monitoring. The 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 operations, and (3) keeping the entity head and the Congress informed about problems and deficiencies, including the progress of corrective actions. The auditor should assess the effectiveness of the IG or internal audit as a monitoring control. However, if the auditor is the IG, the office should not attempt to assess its effectiveness as a control. Evaluating an IG's office or internal audit includes consideration of its authority and reporting relationships, the qualifications of its staff, and its resources. (In using the work of the IG or internal auditors, refer to section 650.)

IS EFFECTS ON THE CONTROL ENVIRONMENT, RISK ASSESSMENT, COMMUNICATION, AND MONITORING

.41 IS affects the effectiveness of the control environment, risk assessment, communication, and monitoring. For example, controls that normally would be performed by separate individuals in manual systems may be concentrated in one computer application and pose a potential segregation-of-duties problem.

.42 The auditor should consider the following IS factors in making an overall assessment of the control environment, risk assessment, communication, and monitoring. An IS auditor may assist the auditor in considering these factors:

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

- considering the risks and benefits of computer applications;
- communicating policies regarding IS 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, including fraud risk, related to IS;
- 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 IS 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 IS. In decentralized structures, each computer center 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 IS functional areas can affect the control environment. Factors to consider include

- how the position of the Chief Information Officer (CIO) fits into the organizational structure;
- whether duties are appropriately segregated within the IS function, since lack of segregation typically affects all systems;
- the extent to which management external to the IS 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:** Computer 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 IS 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.

FEDERAL MANAGERS' FINANCIAL INTEGRITY ACT OF 1982

.43 In considering the control environment, risk assessment, communication, and monitoring, 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, risk assessment, communication, and monitoring. In this regard, the quality of the FMFIA process is a good indicator of management's (1) philosophy and operating style, (2) assignment of authority and responsibility, and (3) control methods for monitoring and follow-up. The FMFIA process also may be the basis for management's assertion about the effectiveness of internal control (section 2) and about the entity's financial management systems' substantial compliance with FFMIA requirements (section 4). 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.

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

- Read
  - the FMFIA report,
  - important 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 management's 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.

- Determine whether the audit finds different issues from those identified in the FMFIA process. (If so, see section 580 for reporting on FMFIA.)

.45 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 revisions in Transmittal Memorandum No. 2, dated June 10, 1999) 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 that identify 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.

.46 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 use the FMFIA findings in 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 considering risk.

.47 The reliance that the auditor places on management's FMFIA work depends on a number of factors as discussed in FAM 650.

Federal Financial Management Improvement Act of 1996

.48 As part of its FMFIA work, management determines whether its financial management systems comply with the requirements found in OMB Circular A-127, *Financial Management Systems*. Under FFMIA and OMB audit guidance, the auditor is required to report on the financial management systems' substantial compliance with those requirements. Thus, the auditor should assess the systems' compliance based on the guidance referenced in OMB's audit guidance.

.49 During the planning phase, the auditor generally should understand what management did to determine that the agency's systems were in substantial compliance in order to report under FMFIA. The entity may have used the OMB audit guidance, the GAO Financial Management Series of checklists for Systems Reviewed Under the Federal Financial Management Improvement Act of 1996, the draft JFMIP Financial Management Systems Compliance Review Guide (http://www.financenet.gov/financenet/fed/jfmip/fmscrg.pdf) or other tools. The auditor generally should review this documentation in the internal control phase of the audit to determine the degree to which he or she may rely on it. (See section 320.)

.50 If the entity previously had an assessment made of its financial management systems' substantial compliance with these requirements that resulted in lack of substantial compliance, the auditor should read the remediation plan required by FFMIA and note whether the plan appears feasible.

BUDGET FORMULATION

.51 While assessing the control environment, risk assessment, communication, and monitoring, 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 consider

- 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.

[This page intentionally left blank.]

270 - DETERMINE LIKELIHOOD OF EFFECTIVE INFORMATION SYSTEM CONTROLS

.01 Controls are considered IS controls if their effectiveness depends on computer processing. In the planning phase, the auditor (with the assistance of the IS auditor and using FISCAM or equivalent) should determine whether IS controls are likely to be effective and should therefore be considered in the internal control phase. (See section 295 J for a flowchart of steps in assessing IS controls in a financial statement audit.) The procedures to be performed build on those procedures performed while understanding the entity's operations and assessing the effects of IS on inherent risk and the control environment, risk assessment, communication, and monitoring. AU 319 (SAS 55, as amended by SAS 78) requires the auditor to sufficiently understand each of the five components of internal control—control environment, risk assessment, information and communications, monitoring, and control activities—to plan the audit. This understanding should include relevant IS aspects.

.02 Computerized financial management systems are used extensively in the federal government. While many of these systems are mainframe based, numerous other technologies 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,
- compliance controls, and
- certain operations controls (to the extent described in section 275).

.04 For each of the controls to be evaluated and tested, the auditor should distinguish which are IS controls. IS controls–those whose effectiveness depends on computer processing–can be classified into three types (described in section 295 F):

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

Testing of technical IS controls should be performed by an IS auditor as described in section 360. The audit team may assist the IS auditor by testing user controls and application controls involving manual follow-up.

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

.06 If IS controls are not likely to be effective, the auditor (with the assistance of the IS auditor) should obtain a sufficient understanding of control risks arising from IS 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 IS 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> IS controls that are designed to achieve the control objectives (to provide recommendations to improve internal control).

.07 In the planning phase, the auditor and the IS auditor 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 IS auditor should consider the results of past internal and external reviews.

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 control 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 and budget) and compliance (including budget) controls. For 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 the components of internal control relating to the existence and completeness (and valuation is required for GAO audits) assertions relevant to the performance measures reported in the MD&A, in order to report on those controls that have not been properly designed and placed in operation, but does not need to test those controls (see paragraph 275.09).

RELEVANT OPERATIONS CONTROLS

.02 For the 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) become a separate audit, or (3) 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 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 audit guidance requires the auditor to understand the design of internal controls over the existence and completeness (see definition in paragraph 235.02) assertions (and GAO has added valuation as a requirement for its audits) related to the performance measures the entity reports on in the MD&A 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. The procedures the auditor performs to gain the understanding do not need to be extensive but may consist of discussions, observations, and walkthroughs (see AU 319.41-.43).

[This page intentionally left blank.]

280 - PLAN OTHER AUDIT PROCEDURES

.01 The auditor should consider the following areas during the planning phase, even though many 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 (including the potential need for management to inquire of Department of Justice attorneys on a case-specific basis), the auditor should plan the following procedures (which are described in more detail in AU 337) for an appropriate time 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; and

- sending letters of audit inquiry to attorneys (the auditor should consider the aggregation of cases in deciding on the materiality to include in the legal letter to ensure it is sufficiently low).

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 and when standards change, 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. Note that for

federal government auditors, these representations include (1) the effectiveness of internal control, (2) compliance with laws and regulations, and (3) financial management systems' substantial compliance with FFMIA requirements. Additional guidance on management representations is provided in AU 333, AU 801, SSAE 2, and section 1001 (Part II). Also, per SAS 89, a summary of uncorrected misstatements aggregated by the auditor is to be included or attached to the letter, which shall state management's belief that the effects of the misstatements are immaterial to the financial statements taken as a whole, both individually and in the aggregate. (See section 595 D for an example summary of uncorrected misstatements.)

RELATED PARTY TRANSACTIONS

.04 AU 334 and section 1006 provide guidance on audit procedures that should be performed to identify related parties and related party 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 financial 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 In the planning phase, the auditor should consider the audit procedures that will be applied to sensitive payments. Sensitive payments encompass a wide range of executive functions including executive compensation, travel, official entertainment funds, unvouchered expenses, and consulting services. See GAO's technical guideline 8.1.2, *Guide for Review of Sensitive Payments*.

REACHING AN UNDERSTANDING WITH MANAGEMENT AND REQUESTERS

.06 During planning, it is important that the auditor reach an understanding with the entity's management and individuals contracting for or requesting the audit, about the work to be performed, as required by AU 310 and Amendment No. 2 to *Government Auditing Standards* (paragraphs 4.6.3-4.6.9). If the audit is done based on the request of a committee or member of Congress, the auditor should communicate with that committee or member

as well as management. If the audit is required by law or is self-initiated, the auditor should communicate with the committee members or staff who have oversight of the auditee as well as management.

.07 The auditor should communicate with management and the committee or member in writing (preferred) or orally and document the understanding reached in the workpapers. "Commitment" letters may be used to communicate with Congress about the auditor's planned work. In drafting commitment letters, the auditor should consider the matters required to be communicated by the auditing standards. If the audit organization has a general ongoing working relationship with Congress and prior audit reports, there may already be an understanding with the applicable committee or other requester.

.08 Because of an ongoing working relationship with either a requester or management, the auditor may affirm the contents of the prior audit report, since the types of information included in the understanding are generally included in the objectives, scope, and methodology section of the audit report.

.09 Examples of the matters that are generally included in the understanding are the objectives and limitations of the audit and management's and the auditor's responsibilities. These are described in AU 310.06-.07. GAGAS also requires the understanding to relate to the auditor's responsibility for testing and reporting on compliance and internal control.

OTHER AUDIT REQUIREMENTS

.10 GAGAS (section 4.7) also require the auditor to follow up on known material findings and recommendations from previous audits. Generally, a financial audit should cover areas that had findings and recommendations in previous audits. However, the auditor should consider whether any findings and recommendations from the prior year financial audit need follow-up that would not otherwise be covered (for example, findings at locations that would not otherwise be revisited).

.11 During planning, the auditor also should consider the additional requirements in OMB audit guidance for legal letters, management representation letters, and certain agreed-upon procedures. OMB audit guidance has specific dates by which interim and updated legal letters for CFO Act agencies are to be requested and received, specific formats for

summarizing the information in the letters, and a list of specific officials to whom copies of the letters and summaries should be forwarded. The guidance also has an example of a management representation letter. In addition, the guidance requires that certain agreed-upon procedures to be applied to agency payroll offices and requires that reports be submitted to OPM by a specific date.

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 the auditor 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, risk assessment, communications, and monitoring:** Locations at which control risk (particularly concerning the control environment, risk assessment, communication, and monitoring) is high warrant more extensive testing than those where control risk is low.

- **The auditor's consideration of the risk of material misstatement due to fraud:** Locations at which the auditor has considered there may be a greater risk of material misstatement due to fraud warrant more extensive testing than those where he or she has considered a lower risk of material misstatement due to fraud is present.

- **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 computer 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 that cannot be changed locally.

- **The extent of work performed by other auditors:** Work done by other auditors may be used to reduce or eliminate tests at selected locations or to assist in tests of locations not selected. (See section 650.)

- **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, control risk, and other factors. Using common audit programs, workpaper formats, and indexes for the various locations visited makes it easier to plan, review the workpapers, and 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 Reviewer. For example, selecting fewer locations but more items to test at each of those locations may be appropriate in some instances. Although other methods generally 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.

[This page intentionally left blank.]

290 - DOCUMENTATION

.01 The auditor should document relevant information obtained during the planning phase in the documents described in paragraphs 290.03-.06. Also, as described in paragraph 290.07, the auditor should document the understanding reached with the client and management. Information that is likely to be useful in future audits may be documented in a permanent file.

.02 As the audit work is performed, the auditors may become aware of possible reportable conditions or other matters that should be communicated to the auditee. A structured method to document these matters will aid in communicating them to the audit team, management for review, and 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. If this and other documents were prepared in prior years, they need only be updated for changes each year.

.04 The **General Risk Analysis** or an equivalent document 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 (for example, 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. **Methodology used in assessing computer-related controls (section 240):** If the auditor uses a methodology other than the FISCAM, he or she should document the basis for believing that the methodology is equivalent.

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

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

f. **Level of audit assurance (section 260):** The auditor should document the overall level of audit assurance and the justification for the level used. If the level of audit assurance chosen is 95 percent, the auditor may reference the FAM.

g. **Assessment of inherent risk and the overall effectiveness of the control environment, risk assessment, communication, and monitoring, including whether they preclude the effectiveness of specific control activities (section 260):** The auditor identifies and documents any inherent risks or control risks arising from the control environment, risk assessment, communication, and monitoring 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, risk assessment, communication, and monitoring. In addition, the auditor generally should document the entity's basis for its determination of substantial compliance of its systems with FFMIA requirements.

h. **Risk of material misstatement due to fraud (section 260):** The auditor should document

- the fraud risk factors identified and
- the auditor's response to those risk factors, either individually or in combination.

i. **Effects of IS (section 270):** The auditor should document

- a basic understanding of the IS aspects of the financial management system, including the significance of IS to the entity (section 220);
- the inherent risks arising from IS (paragraph 260.17);
- the impact of IS on the control environment, risk assessment, communication, and monitoring (paragraphs 260.41-.42); and
- tentative conclusions on the likelihood that IS controls are operating effectively (section 270).

When the auditor prepares documentation of the above information, the IS auditor generally should review and agree with the content. Tentative conclusions on the likelihood that IS controls are operating effectively should also be reviewed and concurred to by the Audit Director and Assistant Director as part of their reviews of the General Risk Analysis or equivalent. If IS controls are not likely to be effective, the auditor should document supporting evidence and generally should report such findings as discussed in section 580.

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

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

l. **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.

m. **Staffing requirements.**

n. **Audit timing, including milestones.**

o. **Assistance from entity personnel.**

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

.06 The **Account Risk Analysis** or equivalent 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 or equivalent, indicating their insignificance and the consequent lack of audit procedures applied to them. In such instances, the cycle matrix or equivalent need not be prepared.

.07 The auditor should document in the workpapers the understanding reached with the client and management about the work to be performed, as described in section 280.

295 A - POTENTIAL INHERENT RISK CONDITIONS

.01 The specific conditions listed below may indicate the presence of inherent and/or fraud risks. This section is designed to aid the auditor in considering each of the inherent risk factors described in paragraph 260.16 and the fraud risk factors described in paragraphs 260.24-.25 relating to industry conditions, operating conditions and financial stability, and susceptibility of assets to misappropriation, 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 being phased out (being 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.

- Management faces significant pressure to obtain additional funding necessary to stay viable and maintain levels of service considering the

financial or budgetary position of a program, including the need for funds to finance major research and development or capital expenditures.

- Unusually rapid growth occurs in a program.

- Economic conditions are deteriorating among the group served by the entity.

.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 are

  - difficult to audit;
  - subject to significant management judgments (such as estimates);
  - susceptible to manipulation, loss, or misappropriation;
  - susceptible to inappropriate application of an accounting policy; and
  - susceptible to problems with realization or valuation.

- 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.

- Inventory or equipment have characteristics such as small size, high value, high demand, marketability, or lack of ownership identification

(for example, pharmaceutical inventory or military equipment with high street values).

- Many payments are sent to post office boxes.

- Large amounts of payments are sent to outside recipients, as in the cases of grants, medical care reimbursements, or other federal financial assistance.

[This page intentionally left blank.]

295 B - POTENTIAL CONTROL ENVIRONMENT, RISK ASSESSMENT, COMMUNICATION, AND MONITORING WEAKNESSES

.01 The specific conditions listed below may indicate the presence of control environment, risk assessment, communication, and monitoring weaknesses. This section is designed to aid the auditor in considering each of the control environment, risk assessment, communication, and monitoring factors described in paragraphs 260.32-.40 but is not intended to be all inclusive. The auditor should consider any other factors and conditions considered relevant. (If the auditor is doing a more detailed assessment of internal control than is usual in a financial audit, he or she may refer to GAO's exposure draft of *Internal Control Management and Evaluation Tool* for additional and more detailed examples of internal control factors.)

CONTROL ENVIRONMENT

.02 Integrity and Ethical Values

- An appropriate "tone at the top" has not been established and communicated throughout the entity, including explicit moral guidance about what is right and wrong.

- No (or inadequate) formal code of conduct or other policies regarding acceptable practices, conflicts of interest, or expected standards of ethical and moral behavior exists, or employees are unaware of it.

- Employees do not understand what behavior is acceptable or unacceptable, or what to do if they encounter improper behavior.

- Bad news is covered up by management rather than making full disclosure as quickly as possible.

- Management does not quickly address signs that problems exist.

- Employees feel peer pressure to cut corners.

- High decentralization leaves top management unaware of actions taken at lower organizational levels and thereby reduces the chances of getting caught.

- Everyday dealings with employees, auditors, the public, oversight groups, etc., are not generally based on honesty and fairness (for example, overpayments received or supplier underpayments are ignored, or efforts are made to find a way to reject legitimate benefits claims).

- Penalties for improper behavior are insignificant or unpublicized and thus lose their value as deterrents.

- Management has displayed a loose attitude towards internal control, for example, by not providing guidance on when intervention is allowed or not investigating and documenting deviations.

- Pressure is felt to meet performance targets or deadlines that are unrealistic.

- Management displays lack of candor in dealing with oversight committee staff, recipients of the entity's services, or auditors regarding decisions that could have an impact on the entity.

.03 **Commitment to Competence**

- Jobs have not been analyzed to determine the knowledge and skills needed.

- Employees do not seem to have the knowledge and skills they should have to do their jobs, based on the level of judgment necessary.

- Supervision of employees does not compensate for lack of knowledge and skills in their specific jobs.

.04 **Management's Philosophy and Operating Style**

- Management lacks concern about internal control 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 and personnel in other key areas (such as accounting, IS, and internal auditing) 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.

- Lack of interaction of adequate frequency between senior management and operating management, particularly with geographically removed locations.

- Management attitude toward IS and accounting functions is that these are necessary "bean counting" functions rather than a vehicle for exercising control over the entity's activities.

- Management is motivated to engage in fraudulent financial reporting resulting from substantial political pressure creating an undue concern about reporting positive financial accomplishments.

- One or more individuals with no apparent executive position(s) with the entity appear to exercise substantial influence over its affairs or over individual departments or programs (for example, a major political donor or fundraiser).

- Management is excessively concerned with an unqualified opinion on the financial statements rather than with fixing its systems.

.05 **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.
- 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.

.06 **Assignment of 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, including responsibility for information systems and authorizations for changes.
- Appropriate control-related standards and procedures are lacking.

- The number of people, particularly in IS and accounting, with requisite skill levels relative to the size and complexity of the operations is inadequate.

- Delegated authority is inappropriate in relation to the assigned responsibilities.

- Appropriate system of authorization and approval of transactions (for example, in purchasing, grants, and federal financial assistance) is lacking.

- Policies are inadequate regarding physical safeguards over cash, investments, inventory, and fixed assets.

.07 **Human Resource Policies and Practices**

- Human resource 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 inadequate or inadequately maintained.

- Communication of human resource policies and procedures at field locations is inadequate.

- Policies on employee supervision are inappropriate or obsolete.

- Inappropriate remedial actions are taken in response to departures from approved policies and procedures.

- Employee promotion criteria and performance evaluations are inadequate in relation to the code of conduct.

- Job applicant screening procedures for employees with access to assets susceptible to misappropriation are lacking.

- Training is inadequate regarding controls over payments to others for grants, federal financial assistance, etc.

- Mandatory vacations are not required for employees performing key control functions.

.08 **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.

- Management is not involved in determining when, how much, and for what purpose obligations and outlays can be made.

- The planning and reporting systems that set forth management's plans and the results of actual performance are inadequate.

- 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.

.09 **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; consultants' 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.
- Policies on such matters as acceptable business practices, conflicts of interest, and codes of conduct are weak.
- Management does not have an effective legal counsel.

.10 **Oversight Groups (Including Congressional Committees)**

- Oversight groups demonstrate little concern toward controls and the speed with which internal and external auditors' recommendations are addressed.
- Oversight groups have little involvement in and scrutiny of activities.
- Little interaction occurs between oversight groups and the IG and internal and external auditors.
- Oversight groups demonstrate little concern for compliance with applicable laws, regulations, and contractual requirements.

RISK ASSESSMENT

.11 **Setting Objectives**

- Management has not established or communicated its overall objectives to employees or oversight committees.
- No strategic planning has been done, or the strategic plan does not support the objectives.
- The strategic plan does not address high-level resource allocations and priorities.
- The strategic plan, budgets, and/or objectives are inconsistent.
- Management has not established activity-level objectives for all significant activities, or the objectives are inconsistent with each other or with the overall objectives.
- Objectives do not include measurement criteria.

.12 **Analyzing Risks**

- Management has not adequately identified risks to achieving the entity's objectives arising from external sources, including economic conditions, the President, the Congress, OMB, and the media.

- Management has not adequately identified risks arising from internal sources, such as human resources (ability to retain key people) or IS (adequacy of back-up systems in the event of systems failure).

- Once risks are identified, management has not adequately analyzed the risks, including estimating the significance of risks, assessing the likelihood of their occurring, and determining needed actions.

.13 **Managing Change**

- 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.

COMMUNICATION

.14 **Internal Communication**

- The system for communicating policies and procedures is ineffective.

- Formal or informal job descriptions do not adequately delineate specific duties, responsibilities, reporting relationships, and constraints.

- Channels of communication for personnel reporting suspected improprieties are inappropriate.

- Management fails to display and communicate an appropriate attitude regarding internal control.

- Management is not effective in communicating and supporting the entity's accountability for public resources and ethics, especially regarding matters such as acceptable business practices, conflicts of interest, and codes of conduct.

- Management is not receptive to employee suggestions of ways to enhance productivity and quality or other similar improvements.

- Communication across the organization (for example, between procurement and program activities) is inadequate to enable people to discharge their responsibilities effectively.

.15 **External Communication**

- Channels of communication with suppliers, recipients of program services, and other external parties are not open and effective for communicating information on changing needs.

- Outside parties have not been made aware of the entity's ethical standards.

- Management does not appropriately follow up on information received in communications from program service recipients, vendors, regulators, or other external parties.

MONITORING

.16 **Ongoing Monitoring**

- 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 activities.

- 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.

- Management does not periodically compare amounts recorded by the accounting system with physical assets.

- Management allows large numbers of duplicate payments.

- Management does not respond to internal and external auditors' recommendations to strengthen internal control.

- Management does not encourage and consider employee suggestions.

- Personnel do not periodically acknowledge compliance with the code of conduct or sign off to evidence performance of critical control functions.

.17 **FMFIA or Similar Separate Evaluations**

- FMFIA or similar reviews are not conducted by personnel with requisite skills or using a logical and appropriate methodology.

- Auditors note weaknesses that were not included in FMFIA reports.

.18 **Reporting Deficiencies**

- The entity does not have a mechanism for capturing and reporting identified internal control deficiencies from both internal and external sources resulting from ongoing monitoring or separate evaluations.

- Deficiencies are not reported to the person with direct responsibility and to a person at least one level higher or to more senior management for specified types of deficiencies.

- Corrective actions on deficiencies do not take place on a timely basis.
- Underlying causes of problems are not investigated.
- Follow-up to ensure that the necessary corrective action has taken place is not done.

.19 **The Effectiveness of Other Auditors**

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

- Audit coverage over payments made by others (such as states) for grants, federal financial assistance, etc. is inadequate.

- The audit has an inadequate review of computer general and application controls.

- The auditor does not use appropriate tools, such as audit software and sampling.

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

- The audit department does not have an annual internal inspection.

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 Reviewer.

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. Stratification can improve the efficiency of the sample result (reduce the uncertainty of the estimate) by grouping items together that are expected to behave similarly with respect to the audit measure. Stratification can also be used to ensure that items of special interest receive adequate coverage in the sample. 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 fraud risk and sensitive matters or the turnover of key management; and
- special reporting requirements, such as separate reports, special disclosures, or supplementary schedules.

.03 For example, the auditor may stratify locations, based on the amount of total assets, into the following strata: (1) individually material locations (top stratum), (2) relatively significant locations (intermediate stratum), and (3) relatively insignificant locations (bottom stratum). If an entity has 100 locations and if the 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) or classical variables sampling using a multistage approach may be used as described in section 480.

- Another representative sampling method may be used when appropriate. The auditor should consult with the Statistician if classical variables sampling or another representative sampling method is used.

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

.05 Table 295 C.1 illustrates a possible DUS 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). Section 400 provides additional information on calculating the amounts in the table and the various selection methods.

TABLE 295 C.1: EXAMPLE OF DUS SAMPLING

Stratum	Number of locations	Assets	Preliminary estimate of sample size[a]	Actual number of locations tested[b]
Top	5	$ 70,000,000	70	5
Inter-mediate	85	29,000,000	29	29
Bottom	10	1,000,000	1	1
Total	**100**	**$100,000,000**	**100**	**35**

[a] The preliminary estimate of sample size is computed by dividing the total balance by the sampling interval of $1,000,000. 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 $1,000,000, a $2 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, as described in sections 480 and 495 E.

.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 or different audit procedures at locations not previously selected for on-site testing.

.08 In evaluating the result of a sample, the auditor estimates the effects, both quantitative and qualitative, on the financial statements taken as a whole, of any misstatements noted, as discussed in sections 480 and 540. In visiting selected locations, in addition to the issues concerning evaluation of samples in those sections, the auditor should exercise judgment and should apply the following additional procedures:

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

b. Ask management to identify the cause of the misstatement.

c. Obtain evidence as to whether the same or similar types of misstatement exist at other locations (including locations not tested on-site). If the evidence is highly persuasive that the misstatement does not exist at other locations and the Audit Director concurs, the auditor may treat the effect on the entity the same as that on the location. (See paragraph 480.40 for a discussion of requirements for deciding whether evidence is highly persuasive.)

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 cannot 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.

[This page intentionally left blank.]

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 "roll forward 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 roll forward period increases. Although generally accepted auditing standards do not require moderate or low control risk to use interim testing, the auditor should consider inherent, control, and fraud risk in determining whether substantive tests of the roll forward period can be designed to provide a reasonable basis for extending the audit conclusions from the interim testing date to the year end.

.03 The additional audit procedures that should be performed during the roll forward 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, control, and fraud risk:** The auditor should consider the risk of misstatement during the roll forward 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) and fraud risk increase, so does the extent of the additional procedures that should be applied to the roll forward 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 from the interim testing date to 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 internal control occur from the interim date to the year-end date 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 than the balance at the interim date.

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

- **The anticipated level of transaction activity during the roll forward period:** Interim testing generally decreases in effectiveness and efficiency as the level of transaction activity during the roll forward period 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 roll forward period:** As the difficulty of such procedures increases, the efficiency of interim testing generally decreases.

- **The availability of information to test roll forward period activity using substantive analytical procedures, detail tests, 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.

[This page intentionally left blank.]

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 control.

.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), including fraud 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 combined risk is 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.

[This page intentionally left blank.]

295 F - TYPES OF INFORMATION SYSTEM CONTROLS

.01 As discussed in paragraph 270.04, the auditor should identify IS controls. Such controls should be tested by an IS auditor as described in section 300 and in accordance with the FISCAM or equivalent. IS controls can be classified into three types:

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

GENERAL CONTROLS

.02 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 controls, which are control activities, operate. They are classified as

- **entitywide security management program** that provides a framework and continuing cycle of activity for managing risk, developing security policies, assigning responsibilities, and monitoring the adequacy of the entity's computer-related controls;

- **access control** that limits or detects access to computer resources (data, programs, equipment, and facilities), thereby protecting these resources against unauthorized modification, loss, and disclosure;

- **application software development and change control** that prevents unauthorized programs or modifications to an existing program from being implemented;

- **system software control** that limits and monitors access to the powerful programs and sensitive files that (1) control the computer hardware and (2) secure applications supported by the system;

- **segregation of duties** that means having policies, procedures, and an organizational structure established so that one individual cannot control key aspects of computer-related operations and thereby conduct

unauthorized actions or gain unauthorized access to assets or records; and

- **service continuity control** to ensure that when unexpected events occur, critical operations continue without interruption or are promptly resumed and critical and sensitive data are protected.

Chapter 3 of the FISCAM has detailed guidance on evaluating and testing general controls.

.03 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 IS auditor considers security on an overall basis. For instance, the IS auditor may evaluate the entity's use of security access software, including its proper implementation.

- When evaluating general controls at the application level, the IS auditor reviews security controls that limit access to particular applications and related computer files. Thus, the IS auditor 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.

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

inappropriately excluded from the report. Certain user controls are also affected by general controls. For example, a user control 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.

APPLICATION CONTROLS

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

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

.06 FISCAM, in chapter 4, uses control categories that better tie in with the methodology used in the FAM. These categories relate to the financial statement assertions and are as follows.

- **Authorization control.** This category is most closely aligned with the financial statement accounting assertion of existence or occurrence and, therefore, focuses on the validity of transactions. Consequently, it includes controls designed to ensure that transactions are appropriately authorized and approved and represent economic events that actually occurred during a given period.

- **Completeness control.** This category directly relates to the financial statement accounting assertion on completeness and deals with whether all valid transactions are recorded. Also included in this category are reconciliation controls, which not only help detect misstatements relating to transaction completeness, but can also be used to identify the cutoff and summarization misstatements associated with both the existence or occurrence and completeness assertions.

- **Accuracy control.** This category most directly relates with the financial statement assertion on valuation or allocation, which deals with whether transactions are recorded at correct amounts. This control category, however, is not limited to valuation, and also includes controls

designed to ensure that transactions are properly classified and entered into the application correctly.

- **Control over integrity of processing and data files.** These application controls are not limited directly to one specific accounting application assertion, and if deficient could nullify other application controls and allow the occurrence of unauthorized transactions, as well as contribute to incomplete and inaccurate data.

USER CONTROLS

.07 User controls 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 controls are used, computer-generated information should be manually compared with reliable information prepared or verified independently of the computer.

.08 In certain circumstances, user controls may function independently of general controls. For example, a user control may be to manually check the accuracy and completeness of IS-computed transactions against manually prepared records. With the concurrence of the IS auditor, such control activities may be evaluated and tested without testing 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 part of the internal controls covered in OMB's audit guidance. During planning, the auditor should assess related inherent risk and the control environment, risk assessment, communication, and monitoring 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 outlay 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. Appropriations represent 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 receipt 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.

295 H - LAWS IDENTIFIED IN OMB AUDIT GUIDANCE

.01 When identifying significant provisions of laws and regulations (see paragraph 245.02), the auditor should consider the following laws and regulations identified in OMB audit guidance, (CFO Act agency auditors should select the following laws and regulations for testing, as required by OMB audit guidance), in addition to any others that could have a direct and material effect on the financial statements and RSSI. Following each listed law is the subsection in FAM section 800 that contains the compliance summary and audit program for that law.

- Antideficiency Act (codified as amended in 31 U.S.C. 1341, 1342, 1351, and 1517). (FAM section 803).

- Provisions Governing Claims of the United States Government as provided primarily in sections 3711-3720E of Title 31, Unites States Code (including provisions of the Debt Collection Improvement Act of 1996, Pub. L. No. 104-134, 110 Stat. 1321-358, which also is codified in various sections of 5 U.S.C., 18 U.S.C., 26 U.S.C., 31 U.S.C., and 42 U.S.C.). (FAM section 809).

- Federal Credit Reform Act of 1990, Pub. L. No. 100-508, 104 Stat. 1388-610 (codified in various sections of 2 U.S.C.). (FAM section 808).

- Pay and Allowance System for Civilian Employees as provided primarily in Chapters 51-59 of Title 5, United States Code. (FAM section 812).

- Prompt Payment Act (codified as amended in 31 U.S.C. 3901-3907). (FAM section 810).

.02 In addition, the auditor should also consider whether any of the following laws and regulations, generally previously included in OMB audit guidance, are significant laws for the audited entity, per FAM sections 245 and 802. For many of these laws, especially the Budget and Accounting Procedures Act, the CFO Act, FMFIA, and the Single Audit Act, noncompliance is more of an internal control problem rather than a compliance problem and should be reported in the internal control section of the audit report. See FAM section 802 (Part II), General Compliance Checklist, and the referenced section for each law for internal control and compliance testing.

- Budget and Accounting Procedures, 31 U.S.C. 3511. (FAM section 805).

- Chief Financial Officers Act of 1990, as expanded by the Government Management Reform Act of 1994, 31 U.S.C. 901-903. (FAM section 806). (We will revise section 806 to update the compliance summary and audit program for these amendments.)

- Civil Service Retirement Act, 5 U.S.C. 8331 et. seq. (FAM section 813).

- Federal Employees' Compensation Act, 5 U.S.C. 8101 et. seq. (FAM section 816).

- Federal Employees' Group Life Insurance Act of 1980, 5 U.S.C. 8701 et. seq. (FAM section 815).

- Federal Employees Health Benefits Act, 5 U.S.C. 8901 et. seq. (FAM section 814).

- Federal Managers' Financial Integrity Act (FMFIA), 31 U.S.C. 3512. (FAM section 807).

- National Defense Authorization Act for Fiscal Year 1991, section 1405(a), Closing Appropriation Accounts, 31 U.S.C. 1551-1558. (FAM section 804).

- Single Audit Act Amendments of 1996, 31 U.S.C. 7501-7507. (FAM section 811). (We will revise section 811 to update the compliance summary and audit program for these amendments.)

- Federal Employees Retirement System Act of 1986. This was not included in OMB audit guidance but becomes increasingly material each year as the number of employees covered by this act increases and those covered by the Civil Service Retirement Act decreases. We will prepare a new FAM section on the compliance summary and audit program for this act.

295 I - EXAMPLES OF AUDITOR RESPONSES TO FRAUD RISK FACTORS

.01 As discussed in section 260, the auditor is required by AU 316 (SAS 82) to consider the risk of material misstatement to the financial statements due to fraud. Misstatements due to fraud may arise from fraudulent financial reporting or from misappropriation of assets. Examples of fraud risk factors the auditor may encounter in the federal government are found in sections 295 A and B (inherent and control risk factors). Depending on the nature of the programs audited, the auditor may need to consider further risk factors. The auditor generally should consider the cases the IG has investigated or is investigating to obtain ideas of specific risk factors to look for.

.02 In considering the risk factors in those sections, the auditor should note that some of these fraud risk factors will exist in entities where circumstances do not present a risk of material misstatement. Also, specific controls may exist to mitigate fraud risk, even where risk factors are present. The auditor should consider whether identified risk factors, individually and in combination, present a risk of material misstatement of the financial statements.

.03 In addition to the overall responses to the presence of fraud risk factors affecting professional skepticism, assignment of personnel, accounting principles and policies, controls, and/or modification of the nature, timing, and extent of procedures discussed in section 260, the auditor may decide that a specific response to the fraud risk factors identified is required. These are examples of specific responses:

- Conduct surprise or unannounced visits or procedures (such as inventory observations or cash counts).

- Request that physical inventory be taken closer to year end.

- Contact major customers and suppliers orally and in writing for confirmations, request confirmations of specific persons in the organizations, or request confirmation of more or different information.

- Review year-end adjusting entries in detail and investigate any that appear unusual.

- For significant and unusual transactions, especially near year end, investigate the possibility of related parties (see section 1006).

- Perform substantive analytical procedures at a detailed level, such as by location, line of business, or month.

- Interview personnel in areas where fraud risk factors are a concern to obtain their insights about the risk and whether or how controls address the risk.

- Discuss with other auditors who are auditing departments, locations, or programs of the entity, the extent of work necessary to assure that the risk of material misstatement due to fraud resulting from transactions and activities among these components is adequately addressed.

- If a specialist's work is particularly significant, perform additional procedures with respect to some or all of the specialist's assumptions, methods, or findings to determine that the findings are not unreasonable, or engage another specialist to do that (see section 650).

- Perform additional or more focused analytical procedures concerning budget to actual variances and their underlying causes.

- Test a larger sample of disbursement transactions for validity.

.04 If there is an increased risk of material misstatement due to fraudulent financial reporting, example responses include:

- Revenue recognition. Confirm with customers relevant contract terms and absence of side agreements.

- Inventory quantities. Review inventory records to identify locations, areas, or items for specific attention during or after physical inventory. It may be important to count all locations on the same date, or to observe some locations on an unannounced basis. The auditor may examine the contents of boxed items more rigorously, investigate how boxes are stacked or labeled and the quality of the contents, or he or she may do additional testing of count sheets or tags or maintain copies to minimize the risk of subsequent alteration.

- Allowance for loan losses. Perform more detailed analytical procedures (such as analyzing specific credit lines rather than the portfolio taken as a whole), increase the sample size of loans to conclude as to the accuracy of credit risk and adequacy of loan loss allowances for specific loans, or increase the number of confirmation requests to gain further evidence as to existence.

.05 If there is an increased risk of material misstatements due to misappropriation of assets, example responses include the following:

- Evaluate control risk differently at different locations when the risk is greater at specific locations (such as when a large amount of a specific type of asset that is particularly susceptible to such risk is present at some locations), requiring a different response at different locations.

- With a particular asset that is highly susceptible to misappropriation, understanding and testing controls may be important. Also, physical inspection of such assets at or near year end may be appropriate, as well as analytical procedures using a narrow precision in the auditor's expectation.

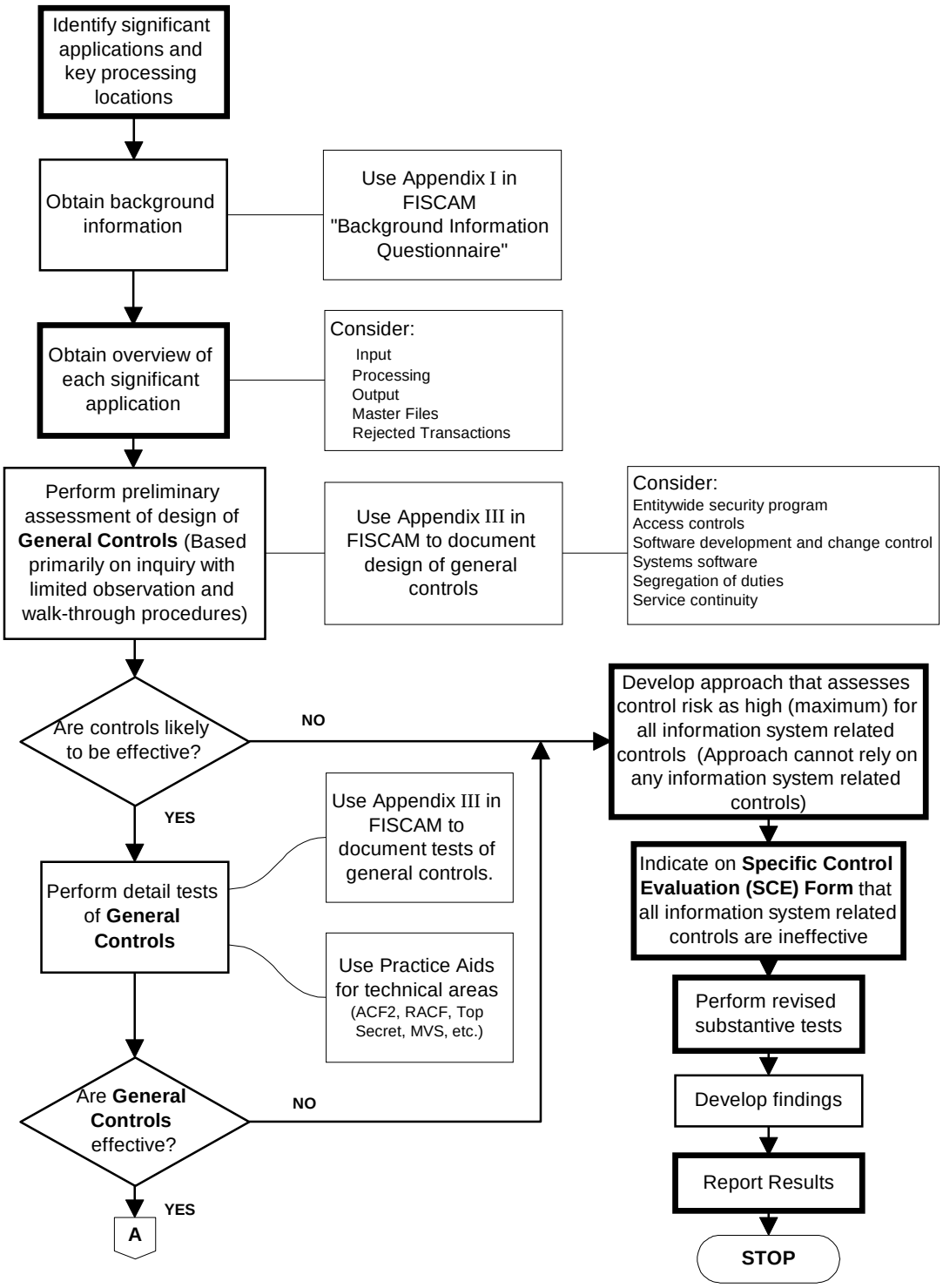
- In some programs, consider additional participant eligibility testing, including unannounced visits to intake centers or work sites to test the existence and identity of participants, or observe benefit payment distribution to identify "ghost" participants, or use confirmation requests to test the existence of program participants.

[This page intentionally left blank.]

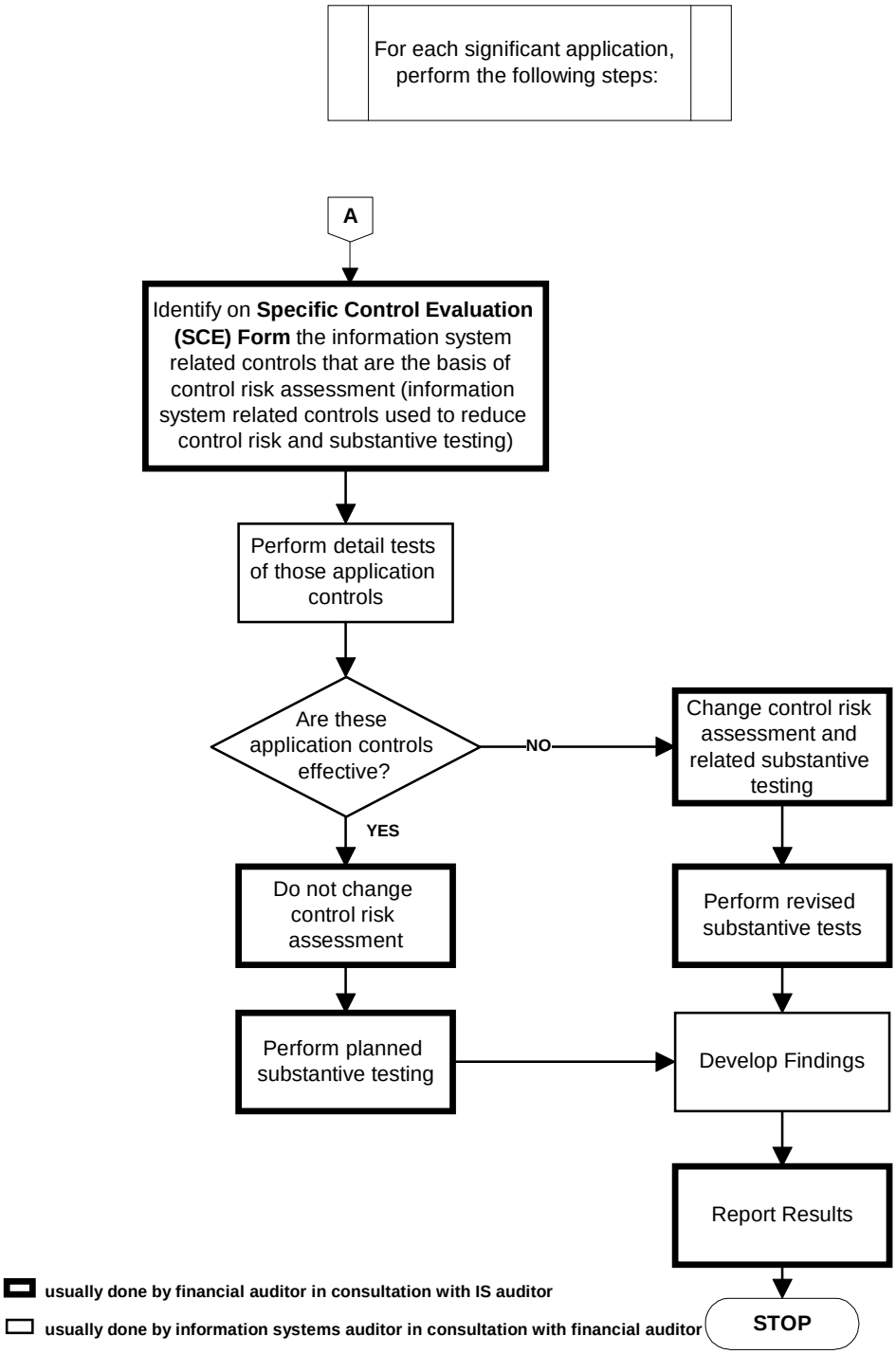
295 J - STEPS IN ASSESSING INFORMATION SYSTEM CONTROLS

.01 As discussed in section 260, the following are the steps the auditor and the IS auditor generally follow in assessing IS controls in a financial statement audit. However, the audit team may decide to test the effectiveness of the general controls even if they are not likely to be effective, or the team may decide to review application controls even though general controls are not effective. The team may decide to do this to be able to make better recommendations on how to fix weak controls.

Steps in Assessing Information System Controls In a Financial Statement Audit



Steps in Assessing Information System Controls In a Financial Statement Audit -- (continued)



[This page intentionally left blank.]

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, assertions, and RSSI	235
• Identify significant cycles, accounting applications, and financial management systems	240
• Identify significant provisions of laws and regulations	245
• Identify relevant budget restrictions	250
• Assess risk factors	260
• Determine likelihood of effective information system 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 information systems	320
• Identify control objectives	330
• Identify and understand relevant control activities	340
• Determine the nature, timing, and extent of control tests and of tests for system's compliance with FFMIA requirements	350
• Perform nonsampling control tests and tests for systems' compliance with FFMIA requirements	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 generally accepted accounting principles	560
• Determine compliance with GAO/PCIE *Financial Audit Manual*	570
• Draft reports	580

310 - OVERVIEW

.01 In the internal control phase, the auditor should obtain evidence about the effectiveness of internal control to (1) assess control risk, (2) determine the nature, timing, and extent of control, compliance, and substantive testing, and (3) form an opinion or report on internal control over financial reporting and compliance. Control risk should be assessed separately for each significant financial statement assertion in each significant cycle/accounting application (including RSSI). (See figure 300.1.) The auditor also should gain an understanding of the components of internal control relating to the existence and completeness assertions (and valuation at GAO) (see definitions of assertions in paragraph 235.02) relevant to the performance measures reported in the MD&A (overview) of the Accountability Report in order to report on controls that have not been properly designed and placed in operation. The auditor is not required to test performance measures controls, but he or she may decide to do so.

.02 The entity's management is responsible for establishing and maintaining internal control to provide reasonable assurance that the entity's objectives will be met. In a financial statement audit, the auditor evaluates those internal controls designed to provide reasonable assurance that the following objectives are met (also see paragraph 310.10 for the auditor's responsibility for performance measures controls):

- Reliability of financial reporting ("financial reporting controls")—transactions are properly recorded, processed, and summarized to permit the preparation of the financial statements and RSSI in accordance with generally accepted accounting principles, and assets are safeguarded against loss from unauthorized acquisition, use, or disposition;

- Compliance with applicable laws and regulations ("compliance controls")—transactions are executed in accordance with (a) laws governing the use of budget authority and other laws and regulations that could have a direct and material effect on the principal statements or RSSI, and (b) any other laws, regulations, and governmentwide policies identified by OMB in its audit guidance.

.03 The auditor should determine whether such internal control provides reasonable assurance that misstatements, losses, or noncompliance, material in relation to the financial statements, would be prevented or detected

during the period under audit. In addition, if the auditor intends to opine on internal control, he or she makes a separate conclusion on internal control as of the end of the period. Additionally, the auditor may test certain operations controls and should understand performance measures controls, as discussed in the planning phase (section 275).

.04 Internal control over safeguarding assets constitutes 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, a part of financial reporting 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. Safeguarding controls are considered as part of financial reporting controls.

.05 Just as safeguarding controls are part financial reporting and part operations controls, budget controls are part financial reporting and part compliance controls. Budget controls that provide reasonable assurance that budgetary transactions, such as obligations and outlays, are properly recorded, processed, and summarized to permit the preparation of the financial statements, mainly the statements of budgetary resources and financing, in accordance with GAAP, are financial reporting controls. Budget controls are generally also compliance controls in that they provide reasonable assurance that transactions are executed in accordance with laws governing the use of budget authority. Some budget controls may be compliance controls only; for example, controls over allotments, to prevent Antideficiency Act violations.

.06 The auditor must evaluate and test certain controls. AU 319 (SAS 55 amended by SAS 78) 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 audit guidance requires the auditor to perform sufficient tests of internal controls that have been properly designed and placed in operation to support a low assessed level of control risk, the auditor may not elect to forgo control tests solely because it is more efficient to extend compliance and substantive audit procedures.

.07 The following are the types of controls to test:

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

- **compliance controls** for each significant provision of laws and regulations (identified in section 245), including **budget controls** for each relevant budget restriction (identified in section 250), 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 also should understand performance measures controls, but is not required to test them. However, the auditor may decide to test them (see section 275).

.08 The auditor does not have to test controls that have not been properly designed and placed in operation. Thus, internal controls that are not effective in design (or in operation, based on prior years' testing) do not need to be tested. If the auditor determined in a prior year that controls in a particular accounting application were ineffective and if management indicates that controls have not improved, the auditor need not test them. On the other hand, if controls have been determined to be effective in design, the auditor must test their effectiveness. In such cases, the auditor may consider using a rotation approach to testing controls over the various accounting applications, as described in section 395 G. If the auditor expects to disclaim an opinion because of scope limitations or inadequate controls, the auditor may limit internal control work to updating the understanding of controls and whether they have been placed in operation. The auditor may do this on a rotating basis. In the year the auditor expects to issue an opinion on the financial statements, the auditor needs a basis of sufficient work on internal control.

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

- Understand the entity's information systems for financial reporting, 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 activities 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).[1] (Sampling control tests, if necessary, are performed in the testing phase, as discussed in section 450.) Testing is not required for performance measures controls.

- On a preliminary basis, based on the evidence obtained, assess (1) the effectiveness of financial reporting, compliance, and relevant operations controls and (2) control and combined risk (see section 370). (Combined risk, which includes inherent and control risk, is discussed in paragraph 370.09).

.10 OMB's audit guidance also defines internal control over performance measures as a process, effected by management and other personnel, designed to provide reasonable assurance that the following objective is met:

- Reliability of performance reporting—transactions and other data that support reported performance measures are properly recorded, processed, and summarized to permit the preparation of performance information in accordance with criteria stated by management.

---

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

OMB requires the auditor to obtain an understanding of the components of internal control relating to the existence and completeness assertions (at GAO, the valuation assertion is also included in the understanding) relevant to the performance measures included in the MD&A and to report deficiencies in the design of those controls that have not been properly designed and placed in operation. Note that the auditor is not required to test internal control over performance measures.

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

[This page intentionally left blank.]

320 - UNDERSTAND INFORMATION SYSTEMS

.01 The auditor should obtain an understanding of the entity's information systems (including methods and records) for processing and reporting accounting (including RSSI), compliance, and operations data (including performance measures reported in the MD&A (overview) of the Accountability Report).[1] The information systems are part of the information and communication component of internal control. The communication portion of this component was considered in section 260. The auditor should obtain sufficient knowledge of each type of system to understand the information in paragraphs 320.03-.07. The auditor may use an IS auditor to assist in understanding and documenting the IS aspects of these systems. The understanding of the systems should be documented in cycle memorandums or other narratives and flow charts.

.02 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. This walkthrough is to confirm the understanding of the system. The IS 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 260.27-.31, the FMFIA report and its supporting documentation may be considered as a starting point for evaluating internal control. The auditor may use management's documentation of systems and internal control 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) and section 650 for further information.)

ACCOUNTING SYSTEM(S)

.03 The auditor should obtain an understanding of and should document the following for each significant cycle and accounting application (including those dealing with RSSI):

- 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 statements and budget information, including significant accounting estimates, disclosures, and computerized processing.

.04 Understanding the processing involved will be important in determining whether the financial management systems substantially comply with federal financial management systems requirements, federal accounting standards, and the SGL at the transaction level, so the auditor can report as required by FFMIA. If the entity is likely to receive an unqualified opinion and to have no material weaknesses in internal control, the auditor should consider testing, while performing nonsampling control tests (see section 350), some of the information the entity provides to support its assertion about the substantial compliance of its systems.

BUDGET ACCOUNTING SYSTEM(S)

.05 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 OMB;
- Establishing and allocating allotments within the entity, including reprogramming of allotments;
- Establishing and recording commitments, if applicable;
- Establishing, recording, and monitoring obligations (undelivered orders);
- Establishing and recording expended authority (delivered orders);

- Establishing and recording outlays;
- Monitoring supplemental appropriations;
- Recording transactions in and adjustments to expired accounts; and
- Monitoring canceled (closed) accounts.

COMPLIANCE SYSTEM(S)

.06 The compliance system includes the entity's policies and procedures to monitor 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)

.07 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 that produce the data used in performance measures reported in the MD&A (overview) of the Accountability 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 design of internal control related to the existence, completeness, and, at GAO, valuation (see definition in paragraph

235.02) assertions 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; and
- The process used to prepare the performance measures from the system-produced data.

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 misstatements (whether caused by error or fraud), losses, or noncompliance material in relation to the principal statements would be prevented or detected. For RSSI, the objectives would relate to controls that would provide reasonable assurance that misstatements, losses, or noncompliance that would be considered material by users of the information would be prevented or detected. Such objectives should cover the following general areas:

- **Financial reporting controls:** Prevent or detect aggregate misstatements in significant financial statement assertions, including assertions relating to RSSI and the statements of budgetary resources and financing. Also, **Safeguarding controls:** Safeguard assets against loss from unauthorized acquisition, use, or disposition.

- **Compliance controls:** Comply with significant provisions of applicable laws and regulations. Also, **Budget controls:** Execute transactions in accordance with budget authority.

- **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 the data used to measure the entity's performance in accordance with criteria stated by management.

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, including RSSI and the statements of budgetary resources and financing. (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 activities.

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 or equivalent documentation.

.04 The auditor should understand how potential misstatements in significant accounting applications could affect the related line item or account at an assertion level. For example, an overstatement of cash receipts typically results in (1) an overstatement of the cash account (by overstating the debit to cash) and (2) an understatement of accounts receivable (by overstating the credit to accounts receivable). To illustrate this concept using the assertions, a misstatement in the existence or occurrence assertion for cash receipts

typically results in misstatements in (1) the existence or occurrence assertion for the cash account and (2) the completeness assertion for accounts receivable.

.05 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 or equivalent 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. GAO has developed sample forms in WordPerfect and MS Word for preparing the ARA and SCE worksheets.

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

.08 Safeguarding controls and segregation-of-duties controls are often critical to the effectiveness of controls over liquid (easily sold or traded), readily marketable assets (such as cash, inventories, or property) that are highly susceptible to theft, loss, or misappropriation in material amounts. These controls are also important when there is an increased risk of fraud. Before selecting specific control activities to test, the auditor should determine whether safeguarding controls are relevant. 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 objectives of budget controls are to provide reasonable assurance that the entity (1) properly records, processes, and summarizes transactions to permit the preparation of the statements of budgetary resources and financing in accordance with GAAP and (2) executes transactions in accordance with budget authority. Section 395 F presents a list of budget control objectives, organized by steps in the budget process. In addition, section 395 D presents a list of selected statutes relevant to the budget and section 395 E describes budget 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 related financial reporting controls.

COMPLIANCE CONTROLS

.10 The objective of compliance controls is to provide reasonable assurance that the entity complies with significant provisions of applicable laws 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 MD&A (overview) of the Accountability 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.

[This page intentionally left blank.]

340 - IDENTIFY AND UNDERSTAND RELEVANT CONTROL ACTIVITIES

.01 For each control objective, based on discussions with entity personnel, the auditor should identify the control activities 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 activity need not be formally documented on the SCE worksheet at this time. The auditor should first screen the activities to identify those that are effective and efficient to test. An IS auditor may assist the auditor in identifying and understanding IS controls.

BASIC UNDERSTANDING OF EFFECTIVENESS OF CONTROL ACTIVITIES

.02 The auditor should obtain a sufficient understanding of the identified control activities to determine whether they are likely to achieve the control objectives, assuming an effective control environment, risk assessment, communication, and monitoring, appropriate segregation of duties, and effective general controls. The purpose of this assumption is to identify any weaknesses in the specific control activities that should be corrected. When other internal control components are poor, there is inadequate segregation of duties, or poor general controls preclude the effectiveness of specific control activities that would otherwise be effective, the testing of such specific control activities may 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

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

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

.04 **Directness** refers to the extent that a control activity relates to a control objective. The more direct the relationship, the more effective that activity may be in achieving the objective. For example, management reviews of inventory reports that summarize the inventory by storage facility may be less effective in preventing or detecting 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, IS input controls (such as the matching of vendor invoices with receiving reports and purchase orders) that require exact matches of data from different sources before a transaction is accepted for processing may be more effective than controls that accept transactions that fall within a broader range of values. On the other hand, controls based on exception reports that are limited to selected information or use more selective criteria may be more effective than lengthy reports that contain excessive information.

.06 **Manner of application** refers to the way in which an entity places a specific control into operation. The manner of application can influence the effectiveness of a specific control. 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.

.09 Based on the understanding of control activities and the determination as to whether they are likely to achieve the control objectives, the auditor reassesses control risk to decide whether to test controls. If control risk is high because the control activities for a particular accounting application are not effective in design or not effective in operation (based on prior years' testing of the control activities and management's indication that they have not improved), the auditor does not need to test the controls. If they are effective, the auditor must test them, but may consider using a rotation approach to testing the controls, as discussed in section 395 G.

[This page intentionally left blank.]

350 - DETERMINE THE NATURE, TIMING, AND EXTENT OF CONTROL TESTS AND OF TESTS FOR SYSTEMS' COMPLIANCE WITH FFMIA REQUIREMENTS

.01 For each control objective, the auditor should (1) identify specific relevant control activities to test, (2) perform walkthroughs to be sure that those controls are in operation, (3) document these control activities on the SCE worksheet or equivalent, (4) determine the nature and timing of control tests, and (5) determine the extent of control tests. Internal control includes IS controls, as discussed further in paragraphs 360.03-.10 and the FISCAM. For the controls over performance measures reported in the MD&A (overview) of the Accountability Report, the auditor does not need to test controls (although he or she may decide to do so), but should identify the activities likely to achieve the objectives, perform walkthroughs to be satisfied that the controls have been placed in operation, and document the controls.

.02 The auditor also should determine the nature, timing, and extent of tests for compliance of the entity's systems with federal financial management systems requirements (which include the Joint Financial Management Improvement Program's series of system requirements documents), federal accounting standards (GAAP - see section 560), and the SGL at the transaction level in order to report in accordance with FFMIA. Substantial compliance includes the ability of the financial management systems to produce reliable financial statements, have effective internal control, and comply with legal and regulatory requirements.

.03 Thus, if it is likely that the opinion on the financial statements will be modified, that the entity has material weaknesses in internal control, or that it has noncompliance with legal and regulatory requirements, then the auditor need not perform specific tests of the systems' compliance with the FFMIA requirements. The auditor will generally have adequate information about the systems to describe the instances of noncompliance and make recommendations, as required by FFMIA, by gaining an understanding of the systems and doing internal control and substantive testing.

.04 If it is likely that the financial statement opinion will be unqualified and internal control will be determined to be effective, the auditor should plan to

test the systems' compliance with the requirements. Many nonsampling control tests will also test for compliance with the systems requirements and the SGL, although determining compliance with federal accounting standards (GAAP) will also require substantive testing. In designing control and substantive tests, the auditor should keep in mind the need to report on compliance with FFMIA requirements so that the control and other tests may serve this dual purpose.

IDENTIFY RELEVANT CONTROL ACTIVITIES TO TEST

.05 For each control objective identified in Section 330, the auditor should identify the control activity, or combination of control activities, 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, risk assessment, communication, or monitoring weaknesses,[2] including those related to IS (as documented in the ARA and/or GRA document or equivalent (see section 260)) and (2) the tentative determination of the likelihood that IS controls will be effective, as determined in the planning phase (see section 270). The auditor should test only the control activities necessary to achieve the objective. For example, the entity may have several controls that are equally effective in achieving an objective. In such a case, the auditor should select and test the control activity 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 of controls that would ordinarily need to be tested and (2) the time that will be required to test the control.

---

[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, risk assessment, communication, and monitoring weaknesses may result in ineffective control activities. If so, the auditor should still identify and test specific control activities, but the extent of such testing should be limited, as discussed in paragraph 340.02.

.06 For those control objectives for which the auditor preliminarily determines that effective control activities exist or are likely to exist, the auditor should test the selected control activities, as discussed in sections 360 and 450. The auditor may test all, or only certain control activities (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 activities 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 control as discussed in section 580. If the entity's management does not agree with the auditor's conclusion that effective control activities do not exist or are unlikely to exist, the auditor may need to perform procedures sufficient to support that conclusion.

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

PERFORM WALKTHROUGHS TO DETERMINE WHETHER THOSE CONTROLS ARE IN OPERATION

.08 Before performing control tests, the auditor should perform one or more walkthroughs to determine whether the control activities are functioning in the manner understood by the auditor. These walkthroughs, designed to confirm the auditor's understanding of the control activities, differ from those performed to confirm the auditor's understanding of the systems in which they operate (see paragraph 320.02). 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 CONTROL ACTIVITIES TO BE TESTED

.09 The auditor should document the control activities to be tested on the SCE worksheet or equivalent. (See an illustration in section 395 H.) (Other components of internal control are generally tested by observation and inquiry in the planning phase. See paragraph 260.09.) 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 an IS control. An IS auditor generally should review and concur with the auditor's identification of IS controls.

DETERMINE THE NATURE AND TIMING OF CONTROL TESTS

.10 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 350.14-.17. Specific types of control tests and methods to apply them are discussed below.

.11 **Observation** - The auditor conducts observation tests by observing entity personnel actually performing control activities in the normal course of their duties. Observation generally provides highly reliable evidence that a control activity is properly applied when the auditor is there to observe it; however, it provides no evidence that the control was in operation at any other time. Consequently, observation tests should be supplemented by corroborative evidence obtained from other tests (such as inquiry and inspection) about the operation of controls at other times.

.12 **Inquiry** - The auditor conducts inquiry tests by making either oral or written inquiries of entity personnel involved in the application of specific control activities to determine what they do or how they perform a specific control activity. Such inquiries are typically open ended. 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.

.13 **Inspection** - The auditor conducts inspection tests by examining documents and records for evidence (such as the existence of initials or signatures) that a control activity was applied to those documents and records. System documentation, such as operations manuals, 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 activities, the auditor should obtain additional evidence on how the controls were applied. Inspection is generally a reliable source of audit evidence and is frequently used in multipurpose testing. Because evidence of performance is documented, this type of test can be performed at any time. The evidence previously obtained from (1) the inspection of documents in 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.

.14 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.

.15 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 the control's operation through observation or inquiry.

.16 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.

.17 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 multipurpose tests to enhance audit efficiency (see sections 430 and 450).

DETERMINE THE EXTENT OF NONSAMPLING CONTROL TESTS

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

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

DETERMINE THE NATURE, TIMING, AND EXTENT OF TESTS FOR SYSTEMS' COMPLIANCE WITH FFMIA REQUIREMENTS

.20 If the auditor believes it is likely that the opinion on the financial statements will be unqualified (or qualifications will not relate to the entity's ability to prepare reliable financial statements), that internal control will be determined to be effective (and the entity will have no reportable conditions impairing its ability to meet the FFMIA requirements, such as computer security weaknesses), and that the auditor will find no instances of noncompliance with legal and regulatory requirements, then the auditor

should consider the other elements of systems' substantial compliance with FFMIA requirements. Besides reliable financial statements, effective internal control, and compliance with laws and regulations, OMB audit guidance references indicators of substantial compliance with each of the three requirements of FFMIA. Lack of substantial compliance with the indicators would typically result in a lack of substantial compliance with one or more of the three requirements.

.21 The determination of substantial compliance with the indicators requires auditor judgment. To assist the auditor in making these judgments, he or she should use the management-provided documentation of the work management did in determining the extent of its systems' compliance with the requirements of FFMIA and for its assertion about the systems' compliance in its FMFIA section 4 report. The documentation may include the Financial Management Series of Checklists for Systems Reviewed Under the Federal Financial Management Improvement Act of 1996 or other tools. If management is unable to provide any documentation, the auditor may conclude that the systems do not substantially comply.

.22 If management has provided documentation to support its assessment of its systems' compliance and the auditor believes the opinion on the financial statements is likely to be unqualified, internal control is likely to be effective, and no noncompliance is likely to be found with legal and regulatory requirements, the auditor generally should perform tests of the systems' compliance. If, for example, management provides the auditor with a checklist detailing the functions the systems are able to perform, the auditor generally should select some significant functions from the checklist and verify that the systems perform them. This verification may be done based on knowledge the auditor has acquired from gaining an understanding of the systems, as well as by additional observation, inquiry, inspection, and walkthroughs as discussed earlier in this section for control tests. The issues discussed earlier in this section with regard to nature, timing, and extent of control tests also apply to tests of systems' compliance with FFMIA requirements. These tests generally should be done concurrently with nonsampling control tests as described in section 360.

360 - PERFORM NONSAMPLING CONTROL TESTS AND TESTS FOR SYSTEMS' COMPLIANCE WITH FFMIA REQUIREMENTS

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

- Request an IS auditor to test IS 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.

.02 Similarly, the auditor should design and conduct tests of the financial management systems' compliance with the three FFMIA requirements, if he or she determined such tests were necessary (see paragraphs 350.02-.04 and 350.20-.22). Many nonsampling control tests will also serve as tests for compliance with FFMIA requirements, especially the systems requirements and the SGL, although testing for federal accounting standards (GAAP) will include substantive testing, done as part of the testing phase.

TESTS OF IS CONTROLS

.03 In an entity that uses information systems to perform accounting functions, the auditor might identify controls whose effectiveness depends on the computer (IS controls). Such IS controls are discussed in more detail in section 295 F. Due to the technical nature of certain IS controls, an IS auditor should perform or supervise tests of such controls and should document conclusions on the effectiveness of IS controls during the audit period. The financial auditor may perform tests of less technical IS controls but the IS auditor should supervise such testing to evaluate the results and to consider such controls in relation to other IS controls.

.04 If IS controls are identified for testing, an IS auditor 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 controls, unless the IS controls that achieve the control objectives are general controls.

.05 The IS auditor 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 IS auditor should consider knowledge obtained in the planning phase. At the conclusion of this step, the IS auditor 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

.06 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 reperformance using appropriate test software. Although sampling is generally not used to test general controls, it may be used to test certain controls, such as those involving approvals.

.07 If general controls are not effectively designed and operating as intended, any application controls identified for testing generally will be ineffective. In such instances, (1) the IS auditor 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 IS controls were supposed to achieve. However, if manual

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

Tests of General Controls at the Application Level

.08 Based on favorable conclusions reached on general controls at the entity or installation level, the IS auditor should evaluate and test the effectiveness of general controls for those applications within which application controls or user controls are to be tested.

.09 If general controls are not operating effectively within the application, application controls and user controls generally will be ineffective. In such instances, the IS auditor 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 controls.

Tests of Application Controls and User Controls

.10 The IS auditor generally should perform or supervise tests of those application controls and user controls necessary to achieve the control objectives where the overall and application-level general controls were determined to be effective.

NONSAMPLING CONTROL TESTS

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

Segregation of Duties

.12 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, especially fraud, in the normal course of duties. Typically, an entity achieves adequate segregation of duties by establishing controls (such as segregating asset custody from recordkeeping functions) to prevent any person from having uncontrolled access to both assets and related records. Paragraph 330.08 describes situations in which the auditor should test segregation of duties.

.13 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 IS provides access to assets, evaluation and testing of IS controls should be designed to identify (1) individuals (including IS personnel) who may use the computer to obtain access and (2) asset access controls over such individuals.

d. For individuals with authorized access to assets over which asset access controls are insufficient, determine whether such individuals can affect

any recording of transactions in the accounting records. If so, segregation of duties is insufficient, unless such access to accounting records is controlled. For example, the person who processes cash receipts may also be able to record entries in the accounting records. Such a person may be in a position to manipulate the accounting records to conceal a shortage in the cash account, unless another individual reviews all accounting entries made by that person. In an IS accounting system, access to assets frequently provides access to records. For example, generation of a check may automatically record a related accounting entry. In such circumstances, a lack of asset access controls would result in inadequate segregation of duties, and the auditor should consider whether other controls would mitigate the effects of this lack of asset access control.

EVALUATING THE RESULTS OF NONSAMPLING TESTS

.14 The auditor should investigate and understand the reasons for any deviations from control activities noted during nonsampling control tests. The auditor may find, for example, that significant subpopulations were not subject to controls or that controls were not applied during a specific period during the year. In such instances, the auditor 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).

.15 Additionally, the auditor should gather sufficient evidence to report the control weakness. As discussed in paragraphs 580.37-.58, the 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.

.16 Finally, the auditor may make preliminary conclusions as to whether the entity's financial management systems substantially comply with federal financial management systems requirements and the SGL at the transaction level. However, a conclusion as to compliance with federal accounting

standards (GAAP) needs to wait for the results of substantive testing, and these preliminary conclusions also need to be revisited at that time.

370 - ASSESS CONTROLS ON A PRELIMINARY BASIS

.01 Based on the evaluation of internal control and results of nonsampling control tests, the auditor should preliminarily assess the effectiveness of internal control during the period (for reporting on internal control in a non-opinion report and for determining the extent of procedures to be performed in the testing phase) and/or as of the end of the period (for an opinion on internal control). Considerations for assessing the effectiveness of IS controls and each type of control (financial reporting (including safeguarding and budget), compliance, and operations) are discussed in paragraphs 370.06-.14 below and in the FISCAM.

.02 To assess the effectiveness of internal control, 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 580.32-.61) and (2) evidence to support the preliminary assessment of the effectiveness of internal control.

INFORMATION SYSTEM RESULTS

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

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

.05 Audit programs and supporting workpapers should be prepared to document the procedures for evaluating and testing the effectiveness of IS 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 control (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.

---

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

.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 control (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 or equivalent.

COMPLIANCE CONTROLS

.11 Based on the results of compliance control tests and other audit procedures, the auditor should

- conclude whether the entity's internal control provides reasonable assurance that the entity complied with the significant provisions of laws and regulations and executed transactions in accordance with budget authority during the period (to assess control risk, to test compliance as discussed in section 460, and/or to report (non-opinion report) on internal control) and/or as of the end of the period (to support the opinion on internal control) and

- report weaknesses in compliance controls that come to the auditor's attention (see paragraphs 580.32-.61).

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.

.12 When forming conclusions on internal control 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 internal control related to budget execution. If audit evidence indicates that internal control might not provide reasonable assurance that the entity executed transactions in accordance with budget authority, the auditor should discuss the legal implications with OGC.

OPERATIONS CONTROLS

.13 If the results of control tests indicate that operations controls were not effective during the period, the auditor should not place reliance on the ineffective operations controls when performing other audit procedures. Based on gaining an understanding of performance measures systems and

other procedures (which may include optional tests of controls), the auditor will have an understanding of the design of performance measures controls as they relate to the existence and completeness assertions (at GAO, the valuation assertion is also included in the understanding) and whether they have been placed in operation. The auditor should report weaknesses in performance measures controls that come to his or her attention. See paragraphs 580.32-.61 regarding reporting of control weaknesses.

REEVALUATION OF CONTROL RISK AND COMBINED RISK ASSESSMENT

.14 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 compliance and operations controls. If the test 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.

[This page intentionally left blank.]

380 - OTHER CONSIDERATIONS

ROTATION TESTING OF CONTROLS

.01 When the entity's control environment, risk assessment, communication, and monitoring are strong and inherent and fraud risk are low, using a rotation approach for testing controls may be appropriate for IS controls. When appropriate, based primarily on favorable results from prior tests and limited work in the current year, the auditor may test IS internal controls of certain cycles/applications on a rotating basis rather than every year. Rotation is generally not appropriate for use in first-time audits where an opinion is expressed or for audits of entities that do not have strong control environments, risk assessment, communication, and monitoring. 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.

[This page intentionally left blank.]

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 or their equivalent.

.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 that should be communicated to the auditee. The auditor generally should document and communicate these as described in paragraph 290.02.

CYCLE MEMORANDUM AND FLOWCHART

.04 The auditor is required to document (AU 319.44) the understanding gained of each component of internal control, among them, the information system (AU 319.36). The auditor should prepare sufficient documentation to clearly describe and illustrate the accounting system; such documentation may include memorandums and flowcharts. Flowcharts provide a good mechanism to document the process and need not be extremely detailed. In some systems, particularly IS, it is difficult to understand the system without a flowchart. For each significant cycle, the auditor should prepare a cycle memorandum or equivalent, and a complementary flowchart of the cycle and component accounting application(s) is also recommended. 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, each significant accounting application, and each significant financial management system 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 320.03),[1] and (5) identify major internal controls (overview only). The cycle memorandum may also include information on FFMIA requirements considered to this point, such as systems requirements and the SGL.

- The **flowchart** should complement the related cycle memorandum and summarize the significant transaction flows in terms of (1) input and report documents, (2) processing steps, (3) files used, (4) units involved, and (5) interfaces with other cycles and accounting applications.[2]

.05 The auditor should document the understanding of compliance and relevant operations (including performance measures) control systems in a memorandum and, if applicable, a flowchart addressing each point discussed in paragraphs 320.05-.07.

SPECIFIC CONTROL EVALUATION WORKSHEET

.06 The auditor should document the evaluation of specific control activities in the SCE worksheet or equivalent. Control tests should be documented in a control test audit program and in accompanying workpapers. Any IS control tests 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 or equivalent by completing the internal control phase columns, as illustrated in section 395 I.

---

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

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

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	Pur-chasing	Cash disburse-ments	Payroll	Cash	Accounts receivable	Inven-tory	Property	Accounts payable	Obliga-tion
Cash or FBWT		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						
Obligations			X	X							X

[This page intentionally left blank.]

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 that 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.
Completeness	Transaction-related	
	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	<u>Transaction-related</u>	
	Accuracy: 9. Transactions are recorded at incorrect amounts.	9. Transactions should be recorded at correct amounts.
	<u>Line item/account-related</u>	
	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	<u>Line item/account-related</u>	
	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	<u>Line item/account-related</u>	
	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.

Assertion	Potential misstatement	Control objective
	Consistency: 16. The financial statement components are based on accounting principles different from those used in prior periods. Disclosure: 17. Required information is not disclosed in the financial statements or in the footnotes thereto.	16. The financial statement components should be based on accounting principles that are applied consistently from period to period. 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 fraud. 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.

[This page intentionally left blank.]

395 C - TYPICAL CONTROL ACTIVITIES

AUTHORIZATION

.01 Authorization controls are designed to provide reasonable assurance that (1) transactions, (2) events from which they arise, and (3) procedures under which they are processed are authorized in accordance with laws, regulations, 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; and
- 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 the following:

- 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 fraud in the normal course of duties. Typically, an entity achieves adequate segregation of duties by establishing controls (such as segregating asset custody from recordkeeping functions) to prevent any person from having uncontrolled access to both assets and 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.

- Prenumbered forms are used to record all of an entity's transactions, and accountability is maintained for the sequence of all numbers used. (For example, prenumbered billing documents, vouchers, purchase orders, etc., are accounted for in numerical sequence when they are used, and any numbers missing from the sequence are investigated).

- Receiving reports, inspection documents, 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 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 promptly.

- 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 is also 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 detailed listing of cash receipts prepared independently when mail was opened, and units billed are compared with units shipped).

- Actual operating results (such as personnel cost or capital expenditures for a particular organizational component or an entity as a whole) are compared with approved budgets, and variances are explained.

VALUATION 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 following:

- 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 GAAP, 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 GAAP.

- 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, such as the SGL. 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.

[This page intentionally left blank.]

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 or multiple year appropriations often are referred to as "fixed accounts." Fixed accounts are available for obligation for a definite period of time. "No year" authority or accounts are resources that are available for obligation for an indefinite period of time, usually until the purposes for which they were provided are carried out.

[This page intentionally left blank.]

395 E - BUDGET EXECUTION PROCESS

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

General phases	Events	Accounting recognition
Preparation	Budget submission	None
Approval	Granting budget athority	Appropriations
Execution ↓	Delegation of authority	Apportionment
		Allotment
	Use of authority ↓	Commitment
		Obligation
		Expended
		Outlay

.02 The following budget execution process is of interest to the auditor when testing the statement of budgetary resources and when evaluating an entity's internal control relating to budget execution:[1]

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

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

- OMB makes an **apportionment**, which is a distribution of amounts available for obligation. Apportionments divide amounts available for obligation by specific periods (usually quarters), activities, projects, or

[1] For additional information on budget execution, see OMB Circular A-34, *Instructions on Budget Execution*, November 3, 2000.

objects, or a combination thereof. The amounts so apportioned limit the amount of obligations that may be incurred.

- The entity head (or other authorized employee) makes an **allotment**, which is an authorization to subordinates to incur obligations within a specified amount. The total amount allotted by an entity may not exceed the amount apportioned by OMB. The entity, through its fund control regulations, establishes allotments at a legally binding level for complying with the Antideficiency Act. Suballotments and allowances are further administrative divisions of funds, usually at a more detailed level (i.e., suballotments are divisions of allotments established as needed).

- The entity may make a **commitment**, which is an administrative reservation of an allotment or of other funds in anticipation of their obligation. Commitments are not required by law or regulation nor are they considered formal/official use of budget authority. Rather, commitments are used by entities for financial planning in the acquisition of goods and services and control over obligations and the use of budget authority.

- The entity incurs an **obligation**, which 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 need to comply with 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 to orders for goods and services that have not been delivered (undelivered orders).

  The entity records **expended authority**, which is the reduction of an obligation by the receipt and acceptance of goods and services ordered.

Expended authority means that the budget authority has been used to acquire goods or services.[2]

- The entity records an "**outlay**," which, as used in the President's budget, Congressional budget documents, and the statement of budgetary resources, refers to payments made to liquidate obligations for goods and services. The statement of budgetary resources reconciles obligations incurred net of offsetting collections to net outlays.

- The appropriation account **expires** when, according to the restrictions contained in the appropriation, the appropriation is no longer available for new obligations. Adjustments may be made for valid obligations that were either (1) recorded at an estimated amount that differs from the actual amount[3] or (2) incurred before the authority expired, but were not recorded. Adjustments may be recorded for 5 years after the appropriation expires. For both expired accounts and closed accounts, the entity's obligations and expenditures may not exceed the related budget authority. The auditor should refer to OMB Circular A-34 (2000), sections 30.6-.10, for additional guidance on these types of adjustments and transactions.

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

---

[2] In the normal flow of business, when obligations are incurred, a credit to "undelivered orders" or "unexpended obligations - unpaid" is recorded. When the goods or services are received, the obligation is reduced and a credit to "expended authority - unpaid" (a payable) is recorded. When the obligation is paid and the outlay is made, the transaction is credited to "expended authority - paid." For additional transaction details, see the U.S. *Standard General Ledger Accounting Transactions Supplement* of the *Treasury Financial Manual*.

[3] Amounts of commitments, obligations, and expended authority may differ for a particular item acquired. Commitments are made at "initial" estimates, obligations at "later" estimates," and expended authority at "actual" amounts.

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

- After the 5-year period, the budget authority for the expired accounts is **canceled** and the expired accounts are **closed**. No further adjustments or outlays may be made in those closed accounts. Payments for any outstanding unliquidated obligations in closed accounts may be made from unexpired appropriations that have the same general purpose (but are limited in aggregate to 1 percent of the current year appropriation). For both expired accounts and closed accounts, the entity's obligations and expenditures may not exceed the related budget authority. The auditor should refer to OMB Circular A-34 (2000), sections 30.6-10, for additional guidance on these types of adjustments and transactions.

395 F - BUDGET CONTROL OBJECTIVES

.01 This section lists budget control objectives by steps in the budget process. The auditor may consider these control objectives for either or both of the audit of the statement of budgetary resources (evaluation of financial reporting controls) and/or as part of the compliance control evaluation. The auditor may evaluate many of these controls at the same time as controls over expenses, disbursements, and liabilities.

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 may not be concerned with controls over budgetary commitments because commitments are not required by law or regulation nor are they considered formal/official use of budget authority. 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, as a result of impoundments (rescissions or deferrals), be less than the amount of the apportionments requested by the entity. The auditor should notify OGC of any impoundments that come to his or her attention. OMB may also approve amounts available different from those requested by time period, activities, projects, or objects.

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 occur 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 multiyear appropriation account.

  - The purpose of the obligation is one for which the appropriation was made.

  - The obligation was incurred within the time that the appropriation was made available for new obligations.

  - The obligation did not exceed the amount allotted or appropriated by statute, nor was it incurred before the appropriation became law, unless otherwise provided by law.

  - The obligation complies with any other legally binding restrictions, such as obligation ceilings, identified in the planning phase.

  - The obligation has not subsequently been canceled nor the goods or services received.

  - 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 (2000), the auditor should refer to section 30.7 of that circular for reporting and approval requirements.

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

- The adjustment is recorded during the period when the account is available for adjustments (5 years) and was made for a valid obligation incurred before the authority expired.

- 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 appropriation or fund accounts (also 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. **Expended authority transactions:** The following control objectives relating to expended authority transactions, as defined in section 395 E, are generally the same as those for obligation transactions:

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

- The expended authority transaction does not cause the entity to exceed the amount appropriated by statute
- The expended authority transaction is recorded during the period when the account is available for adjustments (5 years).
- The expenditure is not made out of a closed account.

- **Completeness:** All expended authority transactions and adjustments are recorded.
- **Valuation:** Expended authority transactions and adjustments are recorded at the correct amount.
- **Cutoff:** Expended authority transactions and adjustments are recorded in the proper period.
- **Classification**: Expended authority transactions and adjustments are recorded in the proper appropriation or fund accounts (also by program and by object, if applicable), including the proper appropriation year if the account has multiple years.

g. **Outlay transactions:** The following control objectives relate to outlay transactions (to be considered while auditing cash disbursements):

- **Validity:** Outlays are supported by sufficient evidence such as contractor invoices and receiving reports. The outlay is recorded against an obligation made during the period of availability of the appropriation (not made out of a closed account) and is for a purpose for which the appropriation was provided as evidenced by being in an amount not exceeding the obligation, as adjusted, authorizing the outlay. Use of "first-in, first-out" or other arbitrary means to liquidate obligations based on outlays is not generally acceptable unless supporting evidence demonstrates that, in fact, these estimating techniques reasonably represent the manner in which costs are incurred and should be charged to unliquidated obligations. Accrual of liabilities based on incurred but unbilled contractor costs alone is not sufficient evidence of validity (i.e., it does not ensure that the purpose, time, and amount provisions of an appropriation are met). Internal control over liquidation of the corresponding

obligation by outlays is a safeguard against improper payments, including erroneous, duplicative, or fraudulent contractor billings.

- **Completeness:** All outlays and adjustments are recorded in a timely manner.

- **Classification:** Outlays 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. This is evidenced by "matching" the outlay to the underlying obligation.

h. **Obligation and expended authority balances:** The following control objectives relate to obligation and expended authority balances as of a point in time:

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

- **Substantiation:** Recorded account balances are supported by valid obligations and expended authority transactions.

- **Limitation:** Total obligations plus total expended authority transactions 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 limit the amount of obligations that can be incurred by program or object classification. In addition, total payments of outstanding unliquidated obligations that relate to closed accounts cannot exceed the limits described in A-34 (2000), section 30.10 (for annual accounts, 1 percent of the account's current year appropriation, for multiyear accounts, 1 percent of all appropriations that are available for obligation for the same purpose – this is a single, cumulative limit).

i. **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 in which 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 canceled 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 canceled 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)

j. **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))

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

.01 The Federal Credit Reform Act (FCRA) contains many provisions regarding the recording and reporting of activity related to direct loans, loan guarantees, and modifications of these items for budget accounting purposes. (Definitions of these and other FCRA terms are 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 budget control objectives related to FCRA. Additional guidance on FCRA accounting for budget purposes is included in OMB Circular A-34 (2000), section 70, *Federal Credit Programs*. Also, see Federal Financial Accounting and Auditing Technical Release No. 3, *Preparing and Auditing Direct Loan and Loan Guarantee Subsidies Under the Federal Credit Reform Act*, issued by FASAB's Accounting and Auditing Policy Committee (AAPC) in July 1999.

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. **Expended authority transactions:** Expended authority transactions include transactions that occur when loans are disbursed. The following

are supplemental control objectives related to expended authority transactions under FCRA:

- **Valuation:** Expended authority transactions are recorded at the proper amount. The same specific criteria for the amounts of FCRA obligations are also applicable to expended authority transactions.

- **Cutoff:** Expended authority transactions are recorded in the proper period.

  - Expended authority transactions for the cost of loans or guarantees are recorded in the fiscal year in which the direct or guaranteed loan is disbursed or 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 expended authority balances:** The following are supplemental control objectives related to obligation and expended authority balances under FCRA as of a point in time:

- **Limitation:** Total obligations plus total expended authority 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. (The auditor should 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. (The auditor should 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 nonfederal 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 nonfederal borrower to a nonfederal 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, or modification thereof, 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 nonbudget 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 cost of an outstanding direct loan or loan guarantee from the current estimate of cash flows (2 USC 661c(9)); 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. In addition, "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 Circular A-34, section 70.2(x) 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.

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 work must be performed annually for financial reporting controls in significant cycles/applications not selected for testing. This work consists of

- updating the auditor's understanding of the control environment, risk assessment, communication, and monitoring, accounting system, and financial reporting control activities, including performing walkthroughs, and

- performing any other procedures that may be necessary under the specific circumstances to support the report on internal control 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 control.

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, risk assessment, communication, and monitoring are strong; and inherent and fraud 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.

- 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.

The auditor should consider whether assets susceptible to loss or theft, such as cash on hand or imprest funds, also should be excluded from rotational testing.

.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 audits and

- the current or prior work of another auditor, after the auditor considers the requirements of FAM section 650.

CIRCUMSTANCES UNDER WHICH ROTATION TESTING MAY BE USED

.06 The auditor should exercise 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 and fraud risk.

  The effectiveness of rotation ordinarily diminishes as inherent and fraud risk increase.

- 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 others.

  Work performed by others might be used to reduce tests of financial reporting controls. (See FAM section 650.)

- 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 Reviewer

- 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 reevaluated annually.

395 H - SPECIFIC CONTROL EVALUATION WORKSHEET

The auditor should use the SCE worksheet or equivalent to document the evaluation of control activities 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 compliance (including budget) 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 subobjectives.[1]

5. List control activities selected for testing that achieve each control objective identified above and indicate whether each is an IS control. Section 395 C illustrates typical control activities to achieve financial reporting control objectives. User controls where the user would be able to detect misstatements in the computer-generated information independently of IS is not an IS control.

6. Document the effectiveness of control activities 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 compliance (including budget) 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 ACTIVITIES	IS (Y/N)	EFFECTIVE-NESS OF CONTROL ACTIVITIES	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*		
				1c. Recorded receipts should represent amounts actually received by the entity and should be properly classified.	*$1c_1$. Recorded cash receipts are matched with the appropriate supporting documentation.*	*N*		
					$1c_2$. Entries to the accounting records are reviewed and approved by supervisory personnel.	*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 ACTIVITIES	IS (Y/N)	EFFECTIVE-NESS OF CONTROL ACTIVITIES	W/P REF. & CONTROL TESTING PROGRAM STEP
	Cash	*Accts. Rec.*						
			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*	
					3b. Batch totals of input documents are reconciled to output registers, journals, reports, or file updates.	*Y*		

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 ACTIVITIES	IS (Y/N)	EFFECTIVE-NESS OF CONTROL ACTIVITIES	W/P REF. & CONTROL TESTING PROGRAM STEP
	Cash	*Accts. Rec.*						
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*		
			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 as a result of improper summarization.	*6. The summarization of cash receipt transactions should not be understated.*	*6. Same as procedure 3a and 3b above.*	*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 ACTIVITIES	IS (Y/N)	EFFECTIVE-NESS OF CONTROL ACTIVITIES	W/P REF. & CONTROL TESTING PROGRAM STEP
	Cash	*Accts. Rec.*						
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 ACTIVITIES	IS (Y/N)	EFFECTIVE-NESS OF CONTROL ACTIVITIES	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.

[This page intentionally left blank.]

395 I - ACCOUNT RISK ANALYSIS FORM

.01 The ARA form or equivalent 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, fraud, or control risk factors 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 activities 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.

.03 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)*

ACCOUNT RISK ANALYSIS FORM

PREPARER_____

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

REGION _____

FILE: _____

LINE ITEM: *Accounts Receivable - Net*

DATE _____ Page __ of __

PLANNING PHASE					INTERNAL CONTROL PHASE			TESTING PHASE		
Account		Financial Statement Assertions/Risks	Inherent, Fraud, and Control Risk Factors	Cycle/ Accounting Application	Effective-ness of Control Activities	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, fraud, or control risk factors identified.*	*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)*

ACCOUNT RISK ANALYSIS FORM

PREPARER_____

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

REGION _____

FILE: _____

LINE ITEM: *Accounts Receivable - Net*

DATE _____ Page __ of __

PLANNING PHASE					INTERNAL CONTROL PHASE			TESTING PHASE		
Account		Financial Statement Assertions/Risks	Inherent, Fraud, and Control Risk Factors	Cycle/ Accounting Application	Effective-ness of Control Activities	Control Risk	Combined Risk	Timing I/F	Nature & Extent	W/P Ref.& Audit Step
Name	Balance									
		Completeness: *Accounts receivable are not recorded in a timely manner so as to be included in the financial statements.*	*No significant inherent, fraud, or control risk factors identified.*	*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)*

ACCOUNT RISK ANALYSIS FORM

PREPARER_____

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

REGION _____

FILE: _____

LINE ITEM: *Accounts Receivable - Net*

DATE _____ Page __ of __

PLANNING PHASE					INTERNAL CONTROL PHASE			TESTING PHASE		
Account		Financial Statement Assertions/Risks	Inherent, Fraud, and Control Risk Factors	Cycle/ Accounting Application	Effective-ness of Control Activities	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 fraud or control risk factors identified.* .	*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 with management collectibility from troubled debtors.*	*III-13 to III-18*

ENTITY: *XYZ Agency (XYZ)*

ACCOUNT RISK ANALYSIS FORM

PREPARER_____

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

REGION _____

FILE: _____

LINE ITEM: *Accounts Receivable - Net*

DATE _____ Page __ of __

PLANNING PHASE					INTERNAL CONTROL PHASE			TESTING PHASE		
Account		Financial Statement Assertions/Risks	Inherent, Fraud, and Control Risk Factors	Cycle/ Accounting Application	Effective-ness of Control Activities	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, fraud, or control risk factors identified.*	*Accounts Receivable*	*Effective*	*Low*	*Low*	*F*	*Identify accounts receivable from related parties or major debtors. Review confirmations for indication of guarantees or encumbrances.*	*III-19 to III-22*

ENTITY: *XYZ Agency (XYZ)*

ACCOUNT RISK ANALYSIS FORM

PREPARER_____

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

REGION _____

FILE: _____

LINE ITEM: *Accounts Receivable - Net*

DATE _____ Page __ of __

PLANNING PHASE					INTERNAL CONTROL PHASE			TESTING PHASE		
Account		Financial Statement Assertions/Risks	Inherent, Fraud, and Control Risk Factors	Cycle/ Accounting Application	Effective-ness of Control Activities	Control Risk	Combined Risk	Timing I/F	Nature & Extent	W/P Ref.& Audit Step
Name	Balance									
		Presentation and Disclosure: *Accounts receivable are not properly classified or disclosed in the financial statements, nor are they based on a consistent application of accounting principles.*	*No significant inherent, fraud, or control risk factors identified.*	*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*
Line Item Total	*$876,000,000*									

[This page intentionally left blank.]

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, assertions, and RSSI	235
• Identify significant cycles, accounting applications, and financial management systems	240
• Identify significant provisions of laws and regulations	245
• Identify relevant budget restrictions	250
• Assess risk factors	260
• Determine likelihood of effective information system 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 information systems	320
• Identify control objectives	330
• Identify and understand relevant control activities	340
• Determine the nature, timing, and extent of control tests and of tests for systems' compliance with FFMIA requirements	350
• Perform nonsampling control tests and tests for systems' compliance with FFMIA requirements	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 generally accepted accounting principles	560
• Determine compliance with GAO/PCIE *Financial Audit Manual*	570
• Draft reports	580

410 - OVERVIEW

.01 During the testing phase, the auditor gathers evidence to report on the financial statements, internal control, and the entity's compliance with significant provisions of laws and regulations, including whether the entity's systems are in substantial compliance with the three requirements of FFMIA. (See figure 400.1.) The following types of tests are performed in the testing phase:

- **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 about whether the financial statements and related assertions are free of material misstatement. Further guidance on substantive tests is in section 470.

.02 Sampling is often used in these tests. Sampling requires the exercise of professional judgment as well as knowledge of statistical sampling methods. The following sections provide a framework for applying sampling to financial audit situations, but are not meant to be a comprehensive discussion. Additional background and guidance on sampling is provided in the Auditing Practice Release *Audit Sampling*, published in 1999 by the American Institute of Certified Public Accountants and in *Using Statistical Sampling* published by GAO (accession number 129810). The auditor should consider whether he or she needs to consult with the Statistician for assistance in designing and evaluating samples. The auditor should consider the costs and benefits in determining which type of sampling to use.

.03 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.

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 determines, 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.

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 (multipurpose testing). The auditor generally should minimize the number of separate sampling applications performed on the same population by attempting to effectively achieve as many objectives as possible using the items selected for testing.

.02 As discussed in section 480, there are several methods of selecting items for testing. When determining the selection method to use during a multipurpose test, the auditor generally should use the method considered most appropriate for substantive detail tests in the particular situation. Use of this selection method is usually the most efficient because sampling control and compliance tests generally can be based on any type of 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 appropriate, the auditor may test controls relating to all sample items to provide additional assurance concerning controls.

[This page intentionally left blank.]

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 multipurpose 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.

.02 Sometimes, tests performed with the expectation of obtaining certain results give other results. When this happens, the auditor may wish to expand a sample to test additional items. Unless planned for in advance, this generally cannot be done simply, as discussed in paragraphs 450.17, 460.02, and 480.28; the auditor should consult with the Statistician in such cases.

.03 The auditor should keep in mind that the consideration of the risk of material misstatement due to fraud (discussed in section 260 for planning) is a cumulative process that should be ongoing throughout the audit. During testing, the auditor may become aware of additional fraud risk factors or other conditions that may affect the auditor's consideration of fraud risk factors identified during planning, such as discrepancies in the accounting records, conflicting or missing evidential matter, or problematic or unusual relationships between the auditor and the entity being audited. The auditor should consider whether fraud risk factors or other conditions identified require additional or different audit procedures. (See section 540.)

.04 For CFO Act agencies and components listed in OMB audit guidance the auditor is required to report on the substantial compliance of their financial management systems with the requirements of FFMIA. The auditor should conclude on substantial compliance at the completion of the audit work based on work done in the internal control and testing phases, as discussed in section 540.

[This page intentionally left blank.]

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 walkthroughs in combination with other observation and inquiry tests, the auditor generally should obtain more evidence by inspecting individual items selected using sampling procedures. The auditor may use multipurpose testing to use the same sample to test controls and/or compliance and/or balances (substantive test). This is usually more efficient. Alternatively, the auditor may design a sample to test controls alone. In this case, 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 (including sampling unit and frame), (3) the method of selecting the sample, and (4) the sample design and resulting sample size. The auditor should document the sampling plan in the workpapers. See section 495 E for example workpapers for documenting samples.

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 in units or dollars from 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 activities not followed. For example, the auditor might define a deviation 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 on which the auditor needs to reach a conclusion and 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. If the auditor concludes that the locations should be separate populations, he or she should select separate samples at each location; he or she should evaluate the results of each sample separately.

METHOD OF SELECTION

.05 The auditor should select a sample that he or she expects to be representative of the population. Attribute sampling requires random selection of sample items without considering the transactions' dollar amount or other special characteristics. IDEA or other 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 compliance and operations control tests, the objective is to support the preliminary assessment of the control as effective. In addition, for financial reporting and compliance control tests, there is an objective of obtaining evidence to support the auditor's report on internal control.

.07 To determine the sample size, the auditor uses judgment to determine three factors: the confidence level, the tolerable rate (maximum rate of deviations from the prescribed control that the auditor is willing to accept without altering the preliminary assessment of control effectiveness), and the expected population deviation rate (expected error rate). Once the auditor determines these factors, he or she may use software (such as IDEA) or tables to determine sample size and to determine how many deviations the auditor may find without having to change the control risk assessment. GAO uses Tables I and II. Table I on the following page may 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. The AICPA has other

examples in its guidance, and the GAO factors are within the range of the AICPA examples. If an auditor chooses to use factors other than Tables I and II, he or she should consult with the Statistician.

.08 Tables I and II are based on a 90 percent confidence level. (This confidence level used at GAO is generally appropriate because the auditor obtains additional satisfaction regarding controls through other tests such as substantive tests, inquiry, observation, and walkthroughs.)

.09 Tables I and II are each based on different tolerable rates. 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 that may be detected in each sample to rely on the controls at the determined control risk level. (See paragraphs 450.13-.15 for a discussion of the evaluation of test results.)[1]

[1] Tables I and II assume a large population (generally over 2,000 items). If the population is small, the auditor may ask the Statistician to calculate a reduced sample size and to evaluate the results.

Figure 450.1: 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

.10 For financial reporting controls, if the preliminary assessment of control risk is low or moderate, Table I may be used to determine sample size. OMB audit guidance 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.

.11 For compliance and operations controls, sample sizes may also be determined using Table I.

.12 The auditor may use the sample size indicated for 0 acceptable deviations (45 items). If no deviations are expected, the sample size will be the most efficient for assessing control effectiveness; if no deviations are found, the sample will be sufficient to support the assessment of control risk. However, the auditor may use a larger sample size if control deviations are expected to occur but not exceed the acceptable number of deviations for the table.

EVALUATING TEST RESULTS

Financial Reporting Controls

.13 To evaluate sample results, the auditor needs the number of deviations and the confidence level. The auditor may use software (such as IDEA) or tables to evaluate results.[2] If the auditor used Table I to determine sample size, and deviations are noted that exceed the acceptable number for the sample size, the auditor should follow the guidance below in deciding how to revise the preliminary assessment of control risk:

- **Low control risk:** If the preliminary assessment of control risk is low and if deviations are noted that exceed the acceptable number for Table I, but not Table II, 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 concludes that the controls being tested are not operating effectively and should 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

[2] Using the AICPA guidance, the auditor computes the deviation rate and the upper limit at the desired confidence level (usually the same confidence level used to determine sample size). If the upper limit of deviations is less than the tolerable rate, the results support the control risk assessment. If not, the control risk should be increased in designing substantive tests.

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.

Compliance Controls

.14 If Table I is used to determine sample size and 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 also should determine whether any deviations noted ultimately resulted in noncompliance with a budget-related or other law or regulation.

Operations Controls

.15 If Table I is used to determine sample size and deviations are noted that exceed the acceptable number for the sample sizes shown in 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 the acceptable number of deviations in Table I or II (as applicable), the auditor concludes that the controls are not operating as designed. However, the auditor should consider whether there are other reasons for continuing to test the remaining sample items. For example, 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. Or, the auditor may want to include an interval estimate in the report. The auditor should consult with audit team management and the Statistician before completing the testing of the sample.

.17 If an unacceptable number of deviations is 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 Statistician. The selection and

evaluation of additional sample items cannot be based on Tables I or II or on the formulas used by IDEA.

.18 The auditor should consult with the Statistician when 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).

[This page intentionally left blank.]

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 sampling to select specific transactions for testing compliance. The selection of transactions to test may be combined with tests of financial reporting, compliance, or operations 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). To determine sample size, the auditor needs to make judgments as to confidence level, tolerable rate, and expected population deviation rate. Confidence level should be related to compliance control risk. For example, if the auditor determines compliance controls are effective, he or she may use an 80 percent confidence level; if ineffective, a 95 percent confidence level. Tolerable rate is the rate of transactions not in compliance that could exist in the population without causing the auditor to believe the noncompliance rate is too high. GAO auditors should use 5 percent for this. Since the auditor will assess the impact of all identified noncompliance, many auditors use zero as the expected population deviation rate. Using the above factors yields the following sample sizes:

Compliance Controls	Confidence Level	Minimum Sample Size[1]
Effective	80 percent	32
Not Effective	95 percent	59

[1] Tolerable rate of 5 percent, expected population deviation rate of 0, and a large population (over 2,000 items). If the population is small, the auditor may ask the Statistician to compute a reduced sample size and to evaluate the results.

Since the auditor is reporting compliance on an entitywide basis, the auditor may use these sample sizes on an entitywide basis. Evaluation of test results is discussed in paragraph 460.07. The auditor should test the entire sample, even if 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, in the above example, the auditor should consult with the Statistician to determine the appropriate sample size. The auditor cannot merely choose the other sample size, but may, for example, increase the sample size from 32 to 65 by using sequential sampling and randomly selecting 33 additional items. The Statistician should also evaluate the results when a test is expanded.

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 an auditor-determined percentage of the total amount of the summarized information or the amount of the restriction stated in the provision, if any (GAO generally uses 5 percent for this test materiality). (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 on 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, expended authority, and outlays.)

- **Completeness:** Not all amounts are recorded.

- **Cutoff:** Obligations, expended authority, and outlays are not recorded in the proper period.

- **Recording:** Obligations, expended authority, and outlays are not recorded at the proper amount.

- **Classification:** Obligations, expended authority, and outlays are not recorded in the proper account by program and by object, if applicable, including the proper appropriation year if the account has multiple years. (Examples of program and object classifications are provided in 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.

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, the Special Investigator Unit and conclude whether noncompliance has occurred and the implications of any 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 report on internal control 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.)

.08 For certain laws, such as the Budget and Accounting Procedures Act, the CFO Act, FMFIA, and the Single Audit Act, failure to follow the law (e.g., not filing the CFO Act report on time) may be more properly reported as an internal control problem in the internal control section of the audit report, rather than as noncompliance.

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 financial 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 financial statements are presented fairly in accordance with GAAP. 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). In addition, the auditor should consider whether efficiencies can be achieved by using the concepts of directional testing, as discussed in paragraphs 470.14-.16.

.02 Based on the level of expected overall audit assurance determined in the planning phase of the audit (see paragraph 260.04), the auditor should establish the minimum levels of substantive assurance for each level of combined risk. For example, based on desired overall audit assurance of 95 percent, GAO considers the following minimum levels of substantive assurance for each level of combined risk 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 misstatements that in total exceed materiality. 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 is 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:

- **Confirming** a balance or transaction or the related terms, such as accounts receivable or accounts payable, by obtaining and evaluating direct communication from a third party.

- **Physically observing**, inspecting, or counting tangible assets, such as inventory or property, plant, and equipment, and applying related procedures.

- **Examining supporting documents** to determine whether a balance is properly stated. For example, the auditor might examine invoices for property and equipment purchases.

- **Recalculating,** or 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, examine 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 physical observation of inventory might provide evidence about existence, valuation, 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).

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, when the auditor is using a desired overall audit assurance of 95 percent. GAO auditors should use this audit matrix.

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 net cost 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 may be more efficient. For example, in federal government audits, the availability of budgets and other information may 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 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, because the audit risk generally increases with the length of the intervening period.

- The lower the control risk associated with an entity's internal control, the higher the assurance concerning the information subject to that internal control.

OTHER EFFICIENCIES

.14 In planning tests, the auditor should consider the relationships between recorded amounts to help in achieving efficiencies. For example, in double-entry accounting, a misstatement in one account affects at least one other (related) account. This relationship gives rise to the opportunity for testing more than one account with a single test. Similarly, the relationship between budgetary and proprietary[1] accounts may provide the opportunity for efficiencies in testing.

.15 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

[1] The proprietary accounting system supports the accrual basis of accounting.

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 revenue for completeness may provide substantive evidence about the completeness of accounts receivable. In many instances where double-entry accounting is used, it may 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.

.16 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.

.17 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.

.18 To maximize efficiency, the auditor should combine the testing of budgetary and proprietary accounts where the combination is appropriate. For example, the auditor may combine tests of outlays (on the statement of budgetary resources) with tests of cash disbursements (used to test net costs).

.19 If an entity has budget accounting records but does not maintain separate proprietary accounting records, or the proprietary records are incomplete, the auditor should directly test expended authority produced by the budget system and the items necessary to reconcile the budget to the proprietary accounts.

.20 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).

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 may be 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; some guidelines are provided in paragraph 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. Consider the type of misstatements that could occur and how those misstatements would be detected by the model.

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 ESTABLISHING THE LIMIT

.05 As discussed above, the limit is the amount of the difference between the expected and recorded amounts that can be accepted without further investigation. GAO uses the following guidelines in establishing the limit for each level of reliance on analytical procedures for substantive assurance:

- **Complete reliance:** The limit is 20 percent or less of test materiality.
- **Partial reliance:** The limit is 30 percent or less of test materiality.
- **No reliance:** Substantive analytical procedures are not needed.

INVESTIGATING SIGNIFICANT DIFFERENCES

Causes of significant differences

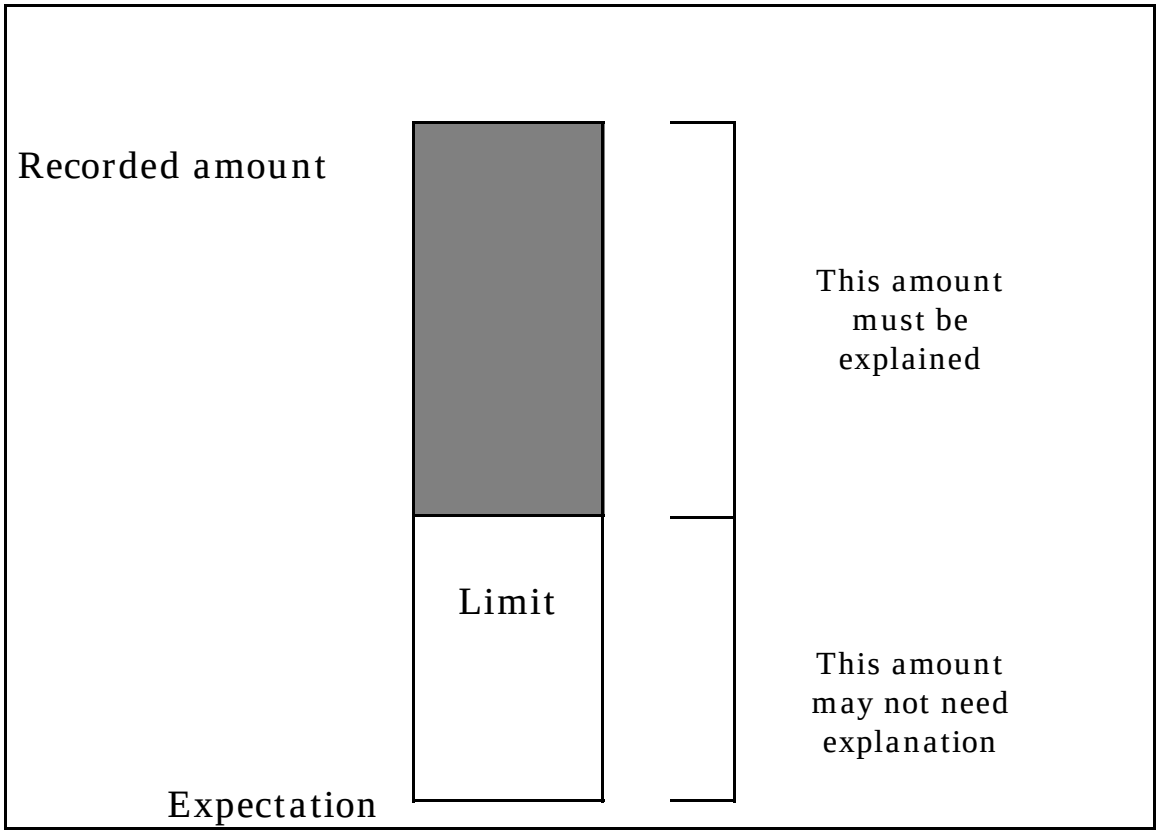
.06 Differences between the expectation and the recorded amount typically relate to either factors not included in the model (such as specific unusual

transactions or changes in accounting policies), a lack of preciseness of the model, or misstatements (either errors or fraud).

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 (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 examining supporting documentation or corroborating explanations received from accounting department personnel with personnel from the appropriate operating department, who should be knowledgeable about the entity's operations. The explanations for the fluctuations should be quantified and should address the direction and magnitude of the event causing the fluctuation. The auditor should 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[1]), or

- using more reliable data or obtaining greater confidence in the data's reliability by corroborating the data to a greater extent.

Measuring the precision of the expectation and the impact of changing each of these factors on the procedure's effectiveness is difficult 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

[1] If the data is disaggregated, the limit is still applied on an annual basis.

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 assurance, the auditor may be able to use those procedures to supplement an understanding of the account balances or transactions after obtaining substantive assurance 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 obtain explanations for.

480 - SUBSTANTIVE DETAIL TESTS

POPULATION TO BE TESTED

.01 In designing detail tests, the assertion tested affects the choice of the population (an account balance or a portion of an account balance) from which items are selected. For example, the existence assertion deals with whether recorded assets or liabilities exist as of a given date and whether recorded transactions have occurred during a given period. To detail test the existence assertion, the auditor should test the recorded account balance by (1) selecting items from those that compose 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 For the existence assertion, 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. If this is not done, the conclusion applies only to the test population (the available items), not the recorded population.

.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 from a source that is likely to contain all the items that should be recorded and (2) determine whether they are included in the recorded balance. For example, to test completeness of recorded revenue, the auditor might select items from a shipping log (which is believed to be reasonably complete), trace them to recorded revenue amounts, and then test the summarization of those amounts to inclusion in the general ledger revenue balance. To test completeness of recorded accounts payable, the auditor might select from payments made subsequent to year-end plus invoices on hand but not yet paid and trace those in which the receipt of goods or services occurred before year-end to inclusion in year-end accounts payable (those where the receipt

occurred after year-end should be tested for exclusion from accounts payable).

SELECTION METHODS FOR DETAIL TESTS

.04 Detail tests may be applied to any of the following:

- all items composing the population;
- a nonrepresentative selection (nonsample) of items; and
- a representative selection (sample) of items composing the population.

Flowchart 1 (section 495 E) illustrates the process of deciding the selection method.

.05 Detail testing of **all items composing the population** is generally most appropriate for populations consisting of a small number of large items. For example, several large accounts receivable or investments might compose an entire balance.

.06 Detail testing of **a nonrepresentative selection (nonsample)** is appropriate where the auditor knows enough about the population to identify which items are of interest, usually because they are likely to be misstated or otherwise have a high risk. (Nonrepresentative selections may also be used to test controls by using inquiry, observation, and walkthrough procedures and to obtain planning information, for example, by performing a walkthrough to understand the items in the population.) While the dollar amount is frequently the characteristic that indicates that an item is of interest, other relevant characteristics might include an unusual nature (such as an item identified on an exception report), an association with certain entities (such as balances due from high-risk financially troubled entities), or a relationship to a particular period or event (such as transactions immediately before and after the year-end date). The effects of any misstatements found should be evaluated; however, unlike sampling, the results of procedures applied to items selected under this method apply only to the selected items and <u>must not be projected to the portion of the population that was 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 or the auditor has already

obtained enough assurance that there is a low risk of material misstatement in the population.

.07 Detail testing of **a representative selection (sample) of items composing the population** is necessary where the auditor cannot efficiently obtain sufficient assurance (based on the assessed combined risk and other substantive procedures including analytical procedures) about the population from nonrepresentative selections. 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 are projected to the entire population. (In random selection, each item has an equal chance of selection; in dollar-unit sampling (DUS), each dollar has an equal chance of selection; in classical variables estimation sampling, each item in a stratum has an equal chance of selection.)

.08 The auditor may use a nonrepresentative selection for part of the population and a sample for the remainder of the population. For example, the auditor might select all inventory items with a book amount greater than $10,000,000, all items that have not had any activity in the previous 6 months, and a statistical sample of the balance of the population. The auditor would project the misstatements in the statistical sample to the population of items less than $10,000,000 with activity in the last 6 months. The auditor would also compute a combined evaluation for the three selections by adding the results of the 100 percent selections to the conclusion for the statistical selections.

.09 The auditor should document in the workpapers (usually in the audit program) whether a selection is intended to be a representative selection (a sample projectable to the population) or a nonrepresentative selection (not projectable to the population); if it is a nonrepresentative selection, the auditor also should document the basis for concluding that enough work has been done to obtain sufficient assurance that the items not tested are free from aggregate material misstatement.

REPRESENTATIVE SELECTIONS (SAMPLING)

.10 The following paragraphs provide an overview of sampling, primarily with respect to the existence and valuation assertions. Similar concepts and

methods apply to the completeness assertion, except that the population for selection differs. (See paragraphs 480.01-.03.)

.11 AU 350.45 indicates that samples may be either statistical or nonstatistical. In statistical sampling, the auditor uses probability theory to determine sample size, select the sample, and evaluate the results for the purpose of reaching a conclusion about the population. Statistical sampling permits the auditor to objectively determine sample size (based on subjective decisions about risk and materiality), objectively select the sample items, and objectively evaluate the results; thus, the auditor using statistical sampling determines objectively whether enough work has been performed. Because of these advantages, when a sample is necessary, the auditor should use statistical sampling. Software such as Interactive Data Extraction and Analysis (IDEA)[1] allows the auditor to quickly perform the calculations necessary for statistical sampling.

[1] IDEA is the primary software GAO uses. It is distributed by Audimation Services, Inc., Houston, Texas.

.12 In nonstatistical sampling, the auditor considers statistical concepts, but does not explicitly use them to determine sample size, select the sample,[2] or evaluate the results. Because the auditor using statistical sampling objectively considers the same factors that the auditor using nonstatistical sampling should subjectively consider, the size of a nonstatistical sample should not be less than the size of a properly calculated statistical sample.

.13 The auditor who uses nonstatistical sampling generally should first calculate a statistical sample size (generally using dollar-unit sampling), then add at least 25 percent. The 25 percent is protection because the nonstatistical sample is not as objective as the statistical sample. The auditor who wishes to use nonstatistical sampling for a particular test should obtain the approval of the Reviewer, in consultation with the Statistician, before performing the test. Approval is not needed to use nonrepresentative selections (nonsampling) since they do not involve projections.

.14 In sampling, the sample must be selected from all the items that compose the population so that each item has an opportunity for selection (in

---

[2] Usually the auditor applying nonstatistical sampling will select a "haphazard sample." A haphazard sample is a sample consisting of sampling units selected without conscious bias, that is, without any special reason for including or excluding items from the sample. It does not consist of sampling units selected in a careless manner; rather it is selected in a way the auditor expects to be representative of the population.

The auditor using a haphazard sample cannot calculate precision at a given confidence level. However, he or she may use the haphazard sample to make a judgment of what a statistical sample might have shown. For example, he or she might use the haphazard sample to make a judgment as to the likely misstatement in areas that are not very significant. Even though the judgment will not be a statistical projection, it will assist the auditor in determining whether the possible misstatement could be material. Thus, the auditor should not avoid making the judgment.

Professional standards and the FAM do not use the term "judgment sample." All selections (including statistical selections) require judgment. The term "judgment sample" is often used to refer to nonrepresentative selections, although it sometimes refers to nonstatistical samples.

statistical sampling, the auditor can determine the probability of 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 composing the population are included in the drawers.

.15 For statistical samples, sample items should be selected using random or dollar-unit selection methods. Computer software may be used. Manual selection should be based on random number tables, a computer-based random number generator, or through use of systematic selection (every *n*th item with a random start between 1 and *n*). For example, the auditor might begin with a random start and then choose 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.

.16 The sample size is a function of the size of the population, the desired confidence level (based on the amount of substantive assurance the auditor requires from detail tests, as shown on the audit matrix in section 495 D), test materiality (based on design materiality, expected misstatements, and other factors discussed in paragraph 230.13), and the sample selection method.

.17 Once the auditor decides that a sample is necessary, the choice of the sample selection method to be used is a matter of the auditor's judgment concerning the most efficient method to achieve the audit objectives. The following methods of sample selection are available for substantive testing:

- dollar-unit sampling (DUS)—see paragraph 480.21,
- classical variables estimation sampling—see paragraph 480.32, and
- classical probability proportionate to size (PPS) sampling—see paragraph 480.34.

Attributes sampling may be used for tests of controls and for tests of compliance with laws and regulations. To use any sampling method for substantive testing that is not listed in this paragraph, the auditor should consult with the Statistician.

.18 Each of these methods yields a valid projected (likely) misstatement, and a valid upper limit at the desired confidence level. In addition, classical PPS

and classical variables sampling yield a valid two-sided confidence interval (DUS yields a valid upper limit). The auditor chooses the method based on the test objectives and efficiency.

.19 When deciding the sampling method, the auditor should consider whether the dollar amounts of the individual items composing 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. Flowchart 2 (section 495 E) summarizes the process of choosing the sampling method once the auditor has decided a sample is necessary. The subsequent pages of the flowchart indicate the steps that the auditor generally should perform for each sampling method. Example workpapers to document attribute, dollar-unit, and classical variables sampling are in section 495 E.

.20 If the dollar amounts of the individual items composing the population are known, the auditor should use DUS, classical PPS, or classical variables estimation sampling. If dollar amounts of these individual items are not known, see paragraph 480.36.

SAMPLE SELECTION

Dollar-unit sampling (DUS)

.21 Dollar-unit sampling (DUS) is a type of statistical sampling that the auditor generally should use when

a. the dollar amounts of individual items in the population are known,

b. the objective is to test the overstatement of the population (see below for testing a population related to the line item),

c. the auditor expects that the total dollar amount of misstatement in the population is not large,[3] and

d. the amount of misstatement in an individual item cannot exceed the selected amount.[4]

DUS is also known as probability proportional to size (PPS) and monetary unit sampling (MUS). DUS works best in populations where the total misstatement is not large and where the objective is to test for overstatement of a population. When the objective is understatement of a line item, the auditor often is able to define a related population to test for overstatement. For example, to test for understatement of accounts payable, the auditor would select a DUS of subsequent disbursements. See also paragraph 480.36.

.22 In a manually applied DUS, a sampling interval (*n*) is used to select every *n*th dollar from the dollars in the individual items that compose the population. These items might be recorded amounts for individual receivable

---

[3] This expectation affects the efficiency of the sample, not its effectiveness. GAO auditors who use IDEA to calculate sample size (based on the binomial distribution) generally use classical variables estimation sampling when they expect that more than 30 percent of the sampling units contain misstatements (no matter what the size of the misstatement). When GAO auditors expect that 30 percent or fewer of the sampling units contain misstatements and the misstatements are expected to be mostly partial misstatements, GAO auditors generally start with dollar-unit sampling. If a large misstatement rate is found, the auditor, in consultation with the Statistician, should consider whether to use classical PPS to evaluate the sample to obtain a smaller precision. Other auditors, in consultation with their Statisticians, may use a different rule of thumb in deciding when to use DUS versus classical variables estimation sampling.

[4] This means, for example, that an item that has a selected amount of $1,000 cannot be misstated by more than $1,000. This is usually not an issue in testing existence or valuation (overstatement). However, it might be an issue in testing completeness (understatement). Thus, if understatements larger than the selected amount are expected, classical variables estimation sampling generally should be used.

balances, inventory items, invoices, or payroll expenses. The item that contains the *n*th 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 an approximately twenty times greater probability of selection than a $100 item).

.23 When the total misstatement in the population is not large, DUS will yield the smallest sample size for a given population, test materiality, and desired confidence level when all statistical sampling methods are considered. When the auditor expects that the population contains a large amount of misstatement, he or she should use classical variables sampling (see footnote 3 and paragraph 480.33).

.24 In DUS, sample size may be computed manually (paragraphs 480.24-.26) or using computer software (paragraph 480.27). Computing a dollar-unit sample size manually uses the dollar amount of the population, test materiality (see section 230), and required confidence level. The auditor calculating sample size manually should use the statistical risk factors in figure 480.1 to determine sample sizes for each confidence level, as discussed below.

Figure 480.1: Statistical Risk Factors

Confidence Level	Statistical Risk Factor[a]
50%	0.7
63%	1.0
77%	1.5
86%	2.0
92%	2.5
95%	3.0

[a] These are based on the Poisson distribution.

Section 495 D contains the audit matrix with the appropriate risk factor for each level of combined risk and reliance on substantive analytical procedures. See paragraph 480.27 for guidance on using IDEA to compute sample size.

.25 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.

.26 For example, to test a recorded amount of $30 million with a test materiality of $900,000 and a 95 percent confidence level, 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: $600,000/$300,000 = 2), thereby making the actual number of items tested fewer than 100.

.27 When the auditor uses the IDEA software to calculate sample size, the inputs are materiality, expected total dollar amount of misstatements in the population, confidence level, and the dollar amount of the population. Whether the auditor should input design materiality or test materiality depends on why the auditor reduced design materiality to get test materiality (see paragraph 230.13). If the auditor reduced design materiality to test materiality because not all entity locations are being tested or because the area is sensitive to financial statement users, the auditor should input test materiality. If the auditor reduced design materiality to test materiality solely because misstatements were expected, the auditor should input design materiality rather than test materiality.

The reason for this is that the auditor inputs the expected dollar amount of misstatements in the population, and the software considers it in adjusting materiality (if the auditor inputs test materiality, the adjustment will have been made twice).

.28 It is difficult to select additional items for a dollar-unit sample after the original sample is selected. If the auditor believes that extension of the sample might be necessary, the auditor generally should plan for that possibility and consult with the Statistician. For example, the auditor might use a 95 percent confidence level (statistical risk factor of 3.0) to select the sample but test only the number of items necessary to achieve the planned confidence level. The items tested should be spread evenly throughout all of the items selected. For example, in a manual selection, if a statistical risk factor of 1.5 is appropriate based on the planned confidence level, 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).

.29 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.

.30 If additional sample items are not selected during the initial sample and it is necessary to select additional items, the auditor should consult with the Statistician to determine how to select the additional sample items. Selection of these additional items may be more complex and less efficient than if they were chosen during the initial sample.

.31 Section 495 F describes how to manually select items using DUS. Computer software, such as IDEA, generally should be used to select a dollar-unit

sample.[5] The choice of selection method used should be based on efficiency considerations.

Classical variables estimation sampling

.32 Classical variables estimation sampling is a type of statistical sampling that the auditor should consider when the auditor expects that one or more of the following exist in the population: the dollar amount of misstatement in the population is large (see footnote 3); individual misstatements may exceed the selected amount of sampling units; significant understatements cannot be identified using other tests; there are no book amounts for each sampling unit; or the auditor cannot add the dollar amounts in the population (see flowchart 2 in section 495 E).

.33 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. Because applying this method is somewhat complex, the auditor should consult with the Statistician before using it. Classical variables sampling and classical PPS require knowledge of the population to determine sample size. In many audits, the auditor learns about the population over several audits and improves the plan each time.

Classical PPS Sampling

.34 Classical PPS Sampling is a type of statistical sampling that the auditor should use when he or she is testing for overstatement of the defined population and finds a large misstatement rate. The sample is selected the same way as a dollar-unit sample (proportionate to size). Since there is no exact way to determine sample size, the auditor uses DUS to calculate sample size. In doing so, the auditor uses a conservative (high) estimate of expected misstatement.

---

[5] IDEA offers two methods of selecting a dollar-unit sample. The auditor generally should use the cell method rather than the fixed interval method. In the cell method, the program divides the population into cells such that each cell is equal in size to an interval. Then the program selects a random dollar in each cell. The random dollar selected identifies the transaction, account, or line item to be tested (sometimes called the logical unit).

.35 Since classical PPS yields a valid measure of likely misstatement and precision, it may be used whenever the only reason for using classical variables sampling otherwise is the expected large misstatement rate.

Sampling when dollar amounts are not known

.36 DUS cannot be used if the dollar amounts of individual items in the population are not known. Classical variables estimation sampling might be used, but this has some difficulties: there is no way to accurately calculate the sample size without the individual dollar amounts, and the method is inefficient unless the auditor finds a large misstatement rate. Lack of individual dollar amounts usually occurs when testing the completeness assertion where the selection is made from a population independent of the population being tested (see paragraphs 480.01-.03). In one approach, the auditor might select a random or systematic sample of the individual items. For example, items might be randomly selected from a shipping log to test the completeness assertion for revenue.

.37 For this type of test, the sample size may be approximated from the total dollar amount of either the population that the auditor is sampling from (the total dollars of the shipping log if the total dollar amount is available) or the dollar amount of the population that the auditor is testing (the total recorded revenue). Because this method is less efficient than DUS, the preliminary estimate of sample size for this sample should exceed the sample size that would result from using DUS. GAO auditors should use at least a 25 percent increase in sample size.[6]

.38 The auditor should consult with the Statistician in performing the evaluation. If the misstatement rate is large, they should consider using classical variables estimation sampling. While attribute sampling may be used to estimate the misstatement rate in the population, this will yield acceptable results only if just one or two misstatements are found. The auditor generally should use the upper limit of the misstatement rate to make a conservative estimate of the dollar amount of misstatement in the population.

---

[6] The 25 percent is a rough estimate that is used because there is no way to calculate the correct sample size.

EVALUATION OF SAMPLE RESULTS

.39 Evaluation involves several steps:

a. Projecting the results of the sample to the population (for nonstatistical samples, making a judgment about likely misstatement in the population).

b. Calculating either the upper limit of misstatement in the population or an interval estimate of misstatement or of the population audited value at the desired confidence level (for nonstatistical samples, considering the risk of further misstatement).

c. Considering the qualitative aspects of misstatements.

d. Reaching a conclusion as to whether the population is fairly stated.

e. Considering the effect of misstatements on the financial statements taken as a whole.

Steps a. and b. are usually done with software such as IDEA in consultation with the Statistician.

.40 The effects of any misstatements detected in a sample should be projected to the population. In doing so, the auditor should ask the auditee to determine the cause of any misstatement found. The auditor should project all misstatements unless he or she has obtained highly persuasive evidence that the misstatement is not representative of the entire population. If the evidence is highly persuasive that a misstatement is not representative of the population, the auditor should (1) perform procedures to test that the same type of misstatement does not exist elsewhere in the population, (2) evaluate the misstatement that is not representative, (3) evaluate the sample, excluding the misstatement that is not representative, and (4) obtain the approval of the Audit Director that the evidence is highly persuasive. 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.

.41 At the conclusion of the test, the auditor also should consider whether the assessment of combined risk remains appropriate, particularly in light of any

misstatements identified. If the preliminary combined risk assessment was not appropriate, the auditor should consult with the Reviewer to determine whether the extent of substantive procedures is adequate.

.42 When understated amounts are detected in any sample designed primarily to test the existence assertion (i.e., designed to test primarily for overstatement), the auditor should consult with the Statistician in evaluating the sample results.

Calculating the projected misstatement for DUS

.43 If the auditor does not use software to evaluate sample results, he or she may calculate projected misstatement as follows. For a misstatement detected in which the item equals or exceeds the amount of the sampling interval (each of which is selected for testing), the projected misstatement is the amount of the misstatement detected. For any other misstatement detected, the projected misstatement is computed 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 percent misstatement, which results in a projected misstatement of $30,000 (10 percent of the $300,000 sampling interval). In this case, the aggregate projected misstatement is $80,000.

Converting a DUS to a Classical PPS sample

.44 If a dollar-unit sample results in a large number of misstatements, it is likely that the evaluation calculated using the method illustrated above would indicate that the upper limit of misstatement in the population exceeds materiality (IDEA indicates the number of misstatements that would yield acceptable results). However, if there are a large number of

misstatements,[7] the auditor, in consultation with the Statistician, should evaluate the sample using classical PPS. This evaluation is complex and cannot be done directly using IDEA.

Evaluating the results of a classical variables estimation sample

.45 The auditor should consult with the Statistician in evaluating the results of a classical variables estimation sample.

Evaluating the results of other samples

.46 When misstatements are detected in a sample for which guidance on evaluation is not described above, the auditor should consult with the Statistician.

EFFECTS OF MISSTATEMENTS ON THE FINANCIAL STATEMENTS

.47 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.

[7] As a general rule, this means 10 misstatements if the sample size is between 75 and 100, 10 percent if the sample size is between 100 and 300, and 30 if the sample size is over 300. Minimum sample size for classical PPS is 75.

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 The auditor also should document, usually in the audit program, whether a selection is intended to be a representative selection (a sample projectable to the population) or a nonrepresentative selection (not projectable to the population). If it is a nonrepresentative selection, the auditor also should document the basis for concluding that enough work has been done to obtain sufficient assurance that the items not tested are free from aggregate material misstatement.

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

.07 Documentation of this phase should specifically include (see section 495 E for example workpapers):

- 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).

[This page intentionally left blank.]

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 net cost 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, net cost 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 fraud, 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 as a result of increases in the number and type of contributing factors, related amounts become more difficult to effectively and efficiently predict.

.10 For example, payroll expense generally is very predictable if there is little employee turnover during the period, if all employees receive the same percentage raise at the same time, and if all employees are salaried. Payroll expense becomes more difficult to predict if any of these factors changes (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 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 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 IG's work is considered adequate. (See FAM section 650.)

.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 that 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 general controls and the specific application controls over the IS 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.

[This page intentionally left blank.]

495 B - EXAMPLE PROCEDURES FOR TESTS OF BUDGET INFORMATION

.01 This section includes example procedures auditors may perform in testing budget information for the statements of budgetary resources and financing.

.02 In addition, 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 obligation and expended authority transactions for these misstatements. (Test materiality for determination of sample sizes is discussed in paragraph 460.03.)

- **Validity, cutoff, recording, and classification:** Select obligations recorded as of the end of the audit period and expended authority transaction recorded during the audit period. Determine if each selected item is a valid obligation or expended authority transaction based on the criteria set forth in section 395 F and if each is recorded in the appropriate period. If the obligation or expended authority transaction 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 appropriation or fund account (also by program and by object, if applicable), including the proper appropriation year.

- **Completeness and cutoff:** First, select a sample of obligations and expended authority transactions 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 expended authority transaction 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 expended authority transaction 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 appropriation or fund account (also 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 expended authority accounts recorded during the audit period. Then reconcile the total of these details to the recorded totals for obligation and expended authority accounts as of the end of the audit period. (Audit software is often an effective tool for footing the transactions recorded in the accounts and for simultaneously selecting items for this test.)

.03 The audit procedures discussed above for testing expended authority transactions should be coordinated with the audit of the other financial statement amounts. For example, if appropriate, the tests of accounts payable for completeness may be coordinated with the selection of subsequent obligations and expended authority transactions described above.

.04 Following is an example of procedures for testing outlay transactions. These audit procedures also should be coordinated with the audit of the other financial statement amounts, chiefly cash disbursements.

- **Validity and classification:** Select outlays recorded during the audit period. Determine if an invoice and receiving report supports each selected outlay and determine the obligation that was liquidated by the outlay. Examine the support for the obligation and determine if the invoice billed for goods or services is related to (or properly "matches") the obligation (and, in turn, the appropriation). Obtain the accounting data of the matched obligation to include appropriation and year. Match

these data to the type of services paid for of the selected outlay. Determine if the related appropriation authorizes payment for the services billed and paid.

[This page intentionally left blank.]

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 auditor has obtained highly persuasive evidence that 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 perform 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 whether 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 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.

[This page intentionally left blank.]

495 D - EXAMPLE OF 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. This example is based on 95 percent audit assurance. The table also provides the statistical risk factors to be used when the auditor manually computes sample size using DUS (see paragraph 480.17).

Figure 495 D.1: Example Audit Matrix

Assessed combined risk level	Substantive assurance	Substantive assurance from analytical procedures[a]	Minimum confidence level for detail tests	Statistical risk factor[b]
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.

[b] Based on the Poisson distribution.

* Not applicable

[This page intentionally left blank.]

495 E - SAMPLING

SAMPLING FLOWCHARTS AND EXAMPLE WORKPAPERS

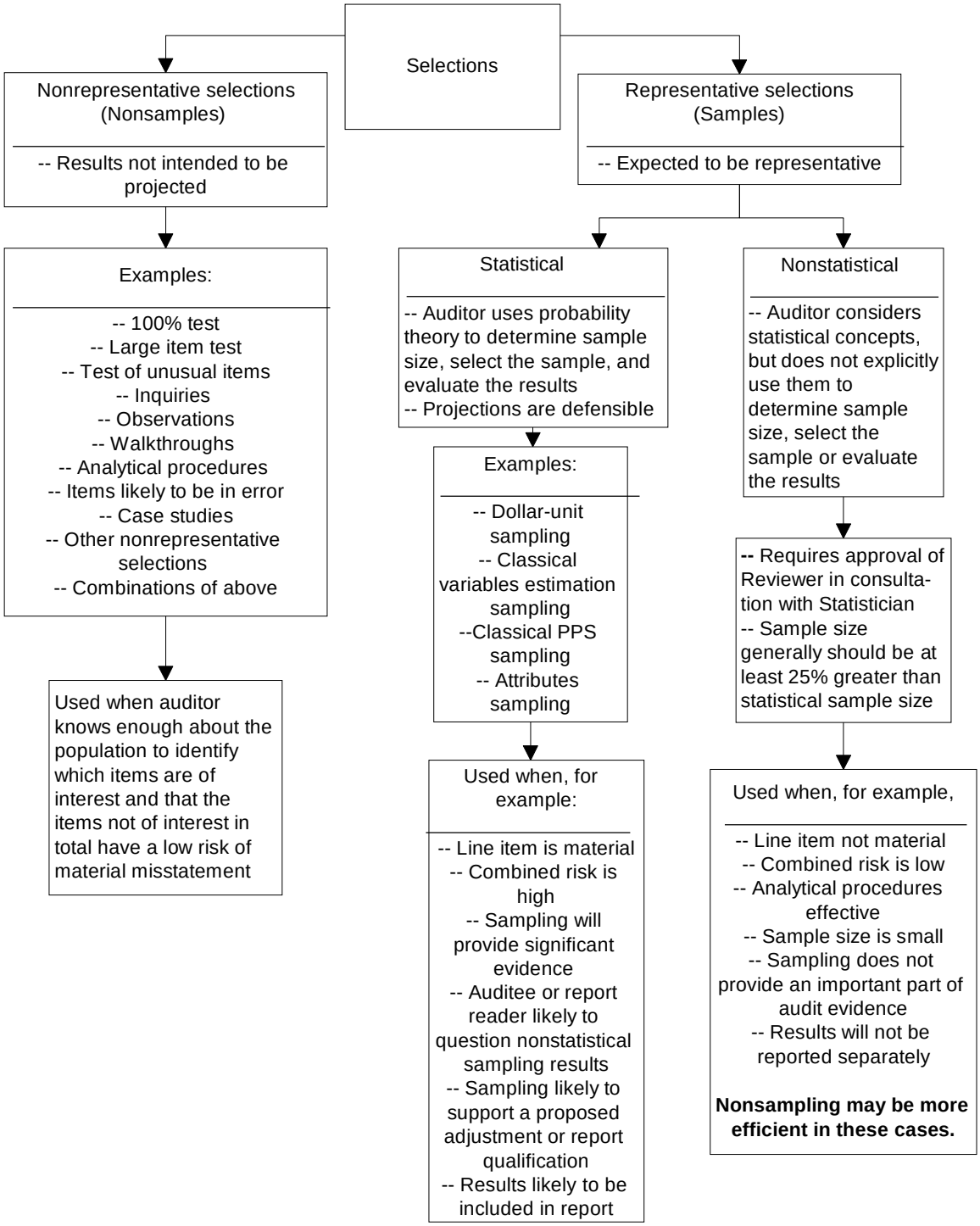
.01 This section contains sampling flowcharts (pages 495 E-2 through 495 E-6) and example workpapers for sampling (pages 495 E-7 through 495 E-19).

.02 Flowchart 1 (page 495 E-2) is to assist the auditor in deciding selection method: nonrepresentative selections versus sampling (statistical or nonstatistical). Flowchart 2 (page 495 E-3) is to help the auditor determine which type of sampling to use in various situations. The second, third, and fourth pages of this flowchart are to assist the auditor in performing attribute, dollar unit, and classical variables estimation sampling.

.03 Example workpapers for documenting sampling are given for attribute sampling (pages 495 E-7 through 495 E-10), for dollar unit sampling (pages 495 E-11 through 495 E-15), and for classical variables sampling (pages 495 E-16 through 495 E-19).

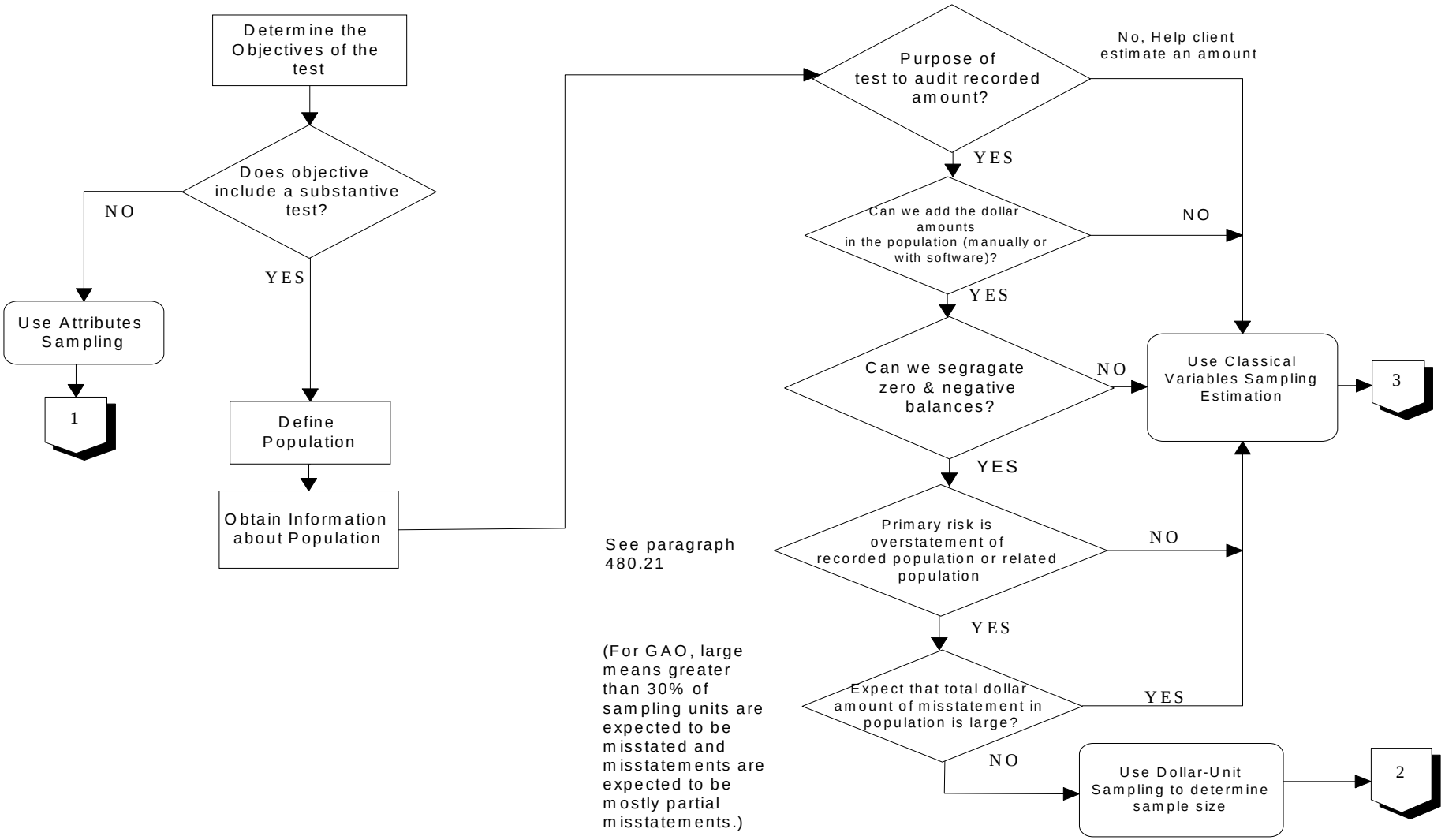
Flowchart 1

DECIDING THE SELECTION METHOD
FOR SUBSTANTIVE, INTERNAL CONTROL AND COMPLIANCE TESTS



Flowchart of the Sampling Process

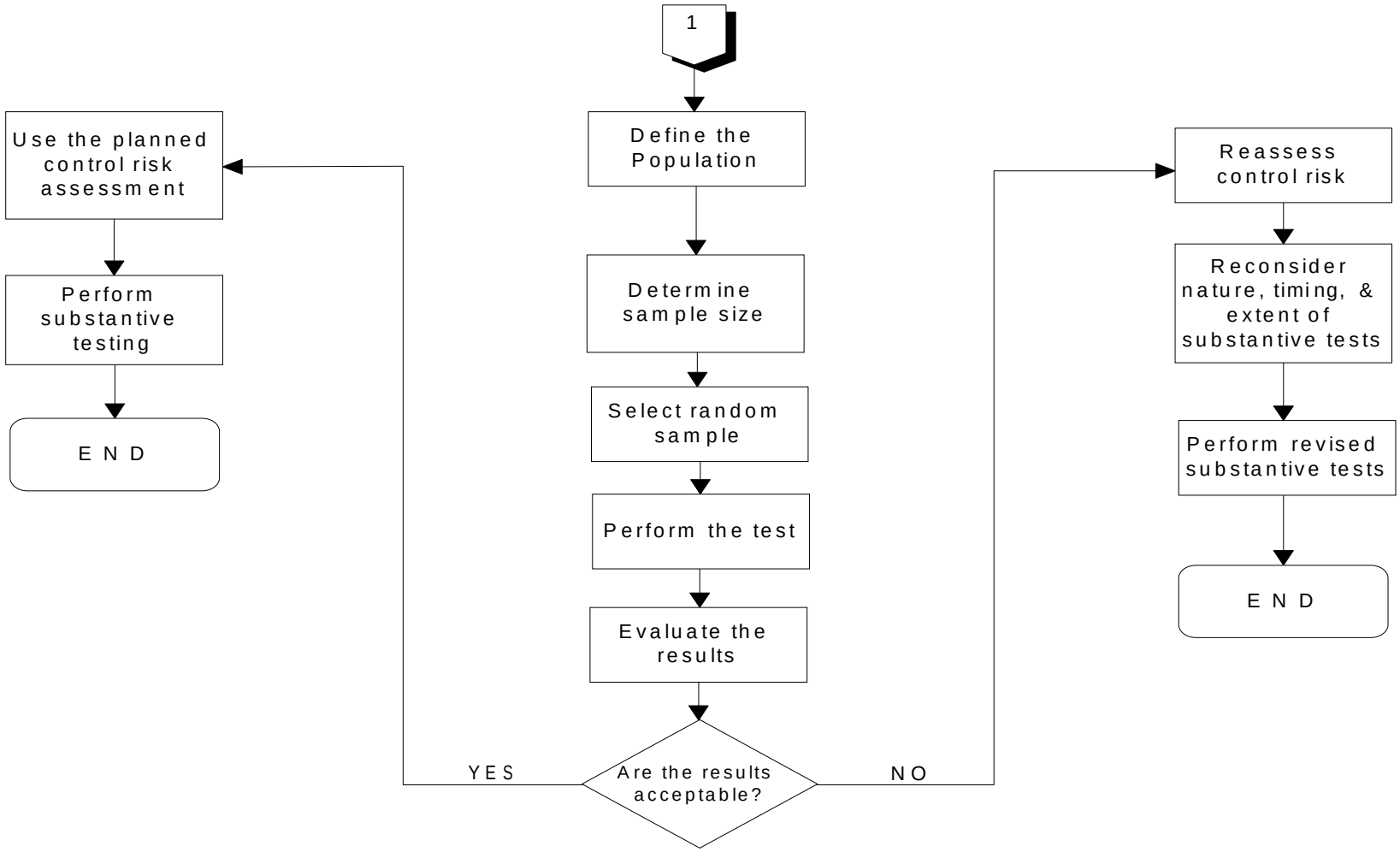
Flowchart 2, p. 1



Flowchart of the Sampling Process

ATTRIBUTES SAMPLING FOR CONTROL TESTS

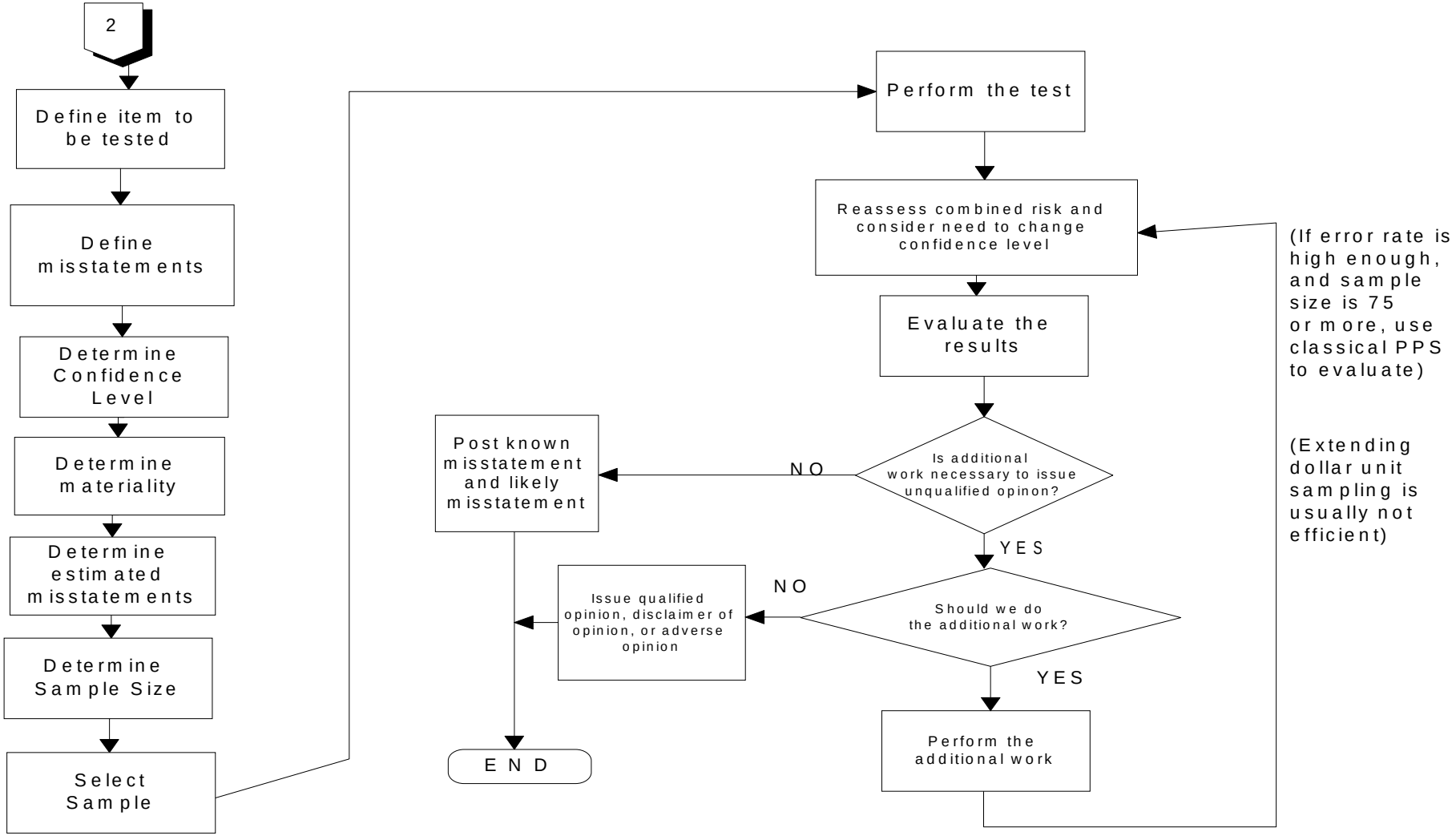
Flowchart 2, p. 2



Flowchart of the Sampling Process

DOLLAR-UNIT SAMPLING

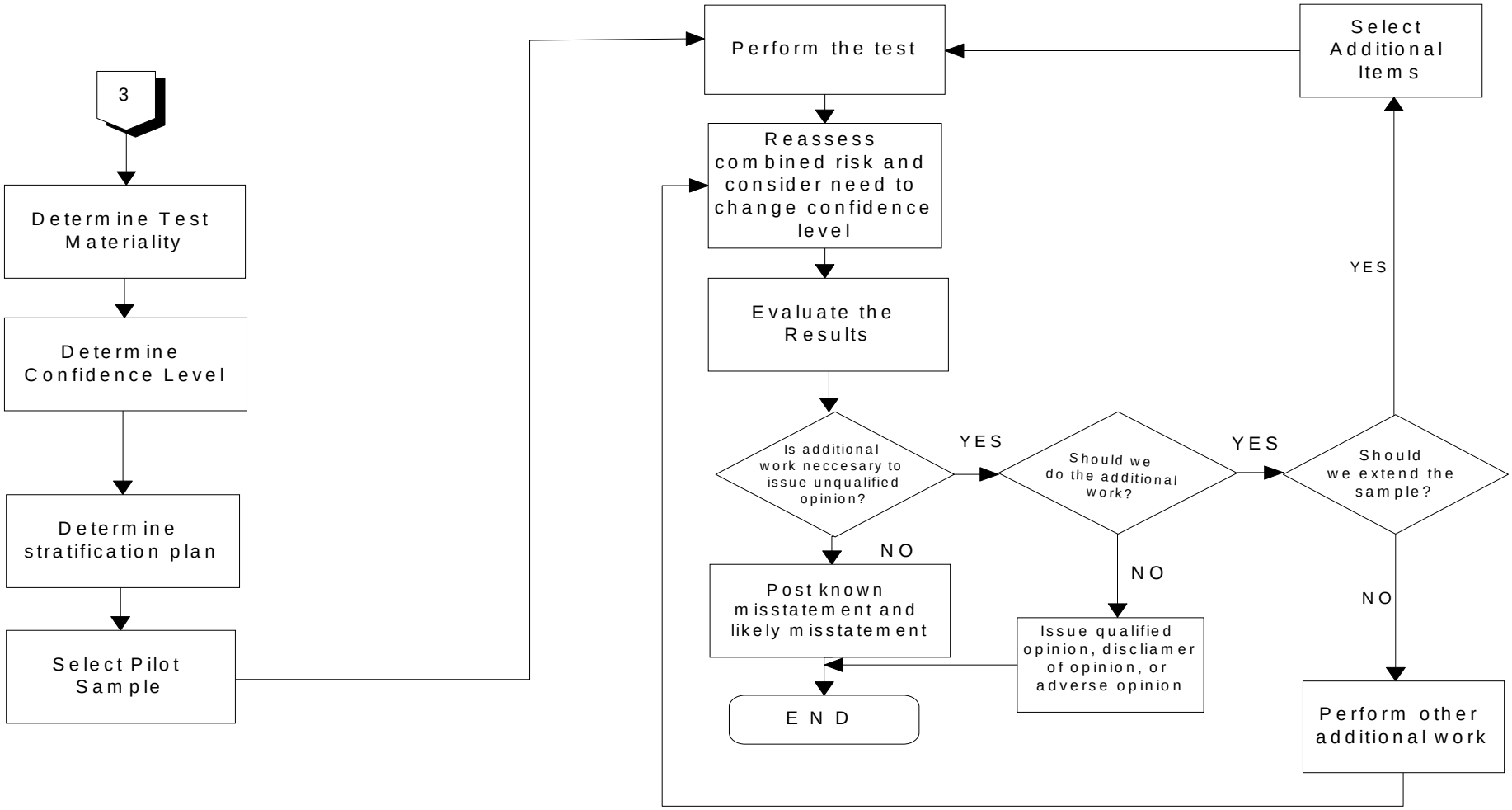
Flowchart 2, p. 3



Flowchart of the Sampling Process

CLASSICAL VARIABLES SAMPLING

Flowchart 2, p. 4



ILLUSTRATIVE WORKPAPERS FOR AUDIT SAMPLING

ATTRIBUTE SAMPLING

Auditee _____

Period Ended _____

	During Planning		At End of Test	
	Initials	Date	Initials	Date
Prepared by	_____	_____	_____	_____
Reviewed by	_____	_____	_____	_____

SECTION I - Definition of control techniques and sampling method

Cycle: _____

Application: _____

Control techniques (from SCE forms): _____
_____

Sampling method:

[ ] Random using IDEA
Workpaper reference to IDEA output _____
[ ] Other—explain _____

SECTION II - Definition of population and attributes to test

Population is: _____

_____

Population size: _____ units

Attribute(s) to test: _____

_____

Document(s) to examine: _____

_____

When this period is less than the entire period under audit or where the population being tested is less than the population in the financial statements, describe briefly (and cross-reference to) procedures for obtaining satisfaction about the remainder of the population:

_____

_____

List steps needed to achieve satisfaction that the selection is from a population equivalent to the defined population:

_____

_____

_____

_____

_____

_____

_____

_____

SECTION III - Determination of sample size and evaluation of sample results:

		A	B	C	D	E
Control activity number	**Deviation definitions (each will constitute a deviation)[1]**	**Preliminary assessment of control risk (see SCEs)**	**Sample size (per Table I in paragraph 450.09)**	**Acceptable number of deviations**	**Number of deviations found**	**Is result acceptable or not acceptable?[2]**

Notes:
1. Insert deviation definitions and data for columns A through C for each control technique before selection of sample.
2. Results are acceptable if column D is less than column C. When results are unacceptable, complete Section IV.

Method of testing when more than one control technique:

[ ] Use largest sample size for all key controls (generally because same documents are tested)
[ ] Use different sample sizes for different controls (using random numbers in order selected)

SECTION IV - Explain unacceptable results and other control deviations

Deviation	Possible cause	Cycles, assertions, and accounts that could be affected	Further action taken	Conclusion/revised control risk assessment*

SECTION V - Overall conclusions about assessed control risk

_____

_____

_____

*Where the preliminary assessment of control risk was low, the risk may be assessed as moderate if the number of deviations found do not exceed the acceptable number of deviations in Table II (paragraph 450.09) for the same sample size.

DOLLAR UNIT SAMPLING

Auditee _____

Period Ended _____

	During planning		At end of test	
	Initials	Date	Initials	Date
Prepared by	_____	_____	_____	_____
Reviewed by	_____	_____	_____	_____

SECTION I - Define objectives and method of testing

Line item: _____

Assertion: _____

Test: _____

SECTION II - Define population

Population is: _____

_____

Population size: _____ dollars

Logical unit (balance or transaction that includes the selected dollar): _____

Direction of test:

Starting from (source): _____
Testing to (documents to be examined): _____

When this period is less than the entire period under audit or where the population being tested is less than the population in the financial statements, describe briefly (and cross reference to) procedures to obtain satisfaction about the remainder of the population: _____
_____
_____
_____

List steps needed to achieve satisfaction that the selection is from a population equivalent to the defined population:
_____
_____
_____
_____
_____

Population analyzed by:
[ ] Review of printout of population
[ ] Review of manual listing of population
[ ] IDEA stratification
[ ] Other computer-assisted method—describe: _____

SECTION III - Determine sample size and interval for DUS

a. Total population (from section II): _____

b. Combined risk from ARA: _____

c. Amount of substantive assurance required (from audit matrix): _____

d. Substantive assurance from analytical procedures that relate to the assertion tested: _____

e. Other substantive tests that relate to the assertion: _____

f. Minimum substantive assurance from detail tests: _____

g. For DUS calculated manually:
   1. Risk factor (from audit matrix): _____
   2. Test materiality: _____

h. For DUS using IDEA:
   1. Confidence level _____%
   2. Materiality (generally design—see FAM 480.27) $_____
   3. Expected misstatement amount $_____

i. Interval based on these factors is: _____
   Random start or seed is _____

j. Sample size based on these factors is: _____
   Workpaper reference to: [ ] Software output (IDEA) _____
   [ ] Manual computation _____

SECTION IV - Evaluation of substantive tests using dollar-unit sampling

If many errors are found and sample size is 75 or greater, consult with Director of Planning and Reporting or designee to evaluate as classical PPS.

Known Substantive Misstatements

Misstatement number	(A) Book amount	(B) Audited amount	(C) Misstatement amount* (A-B)	Nature of misstatement	Possible cause
Items greater than sampling interval					
1	_____	_____	_____	_____	_____
2	_____	_____	_____	_____	_____
3	_____	_____	_____	_____	_____
Total*	_____	_____	_____		

Items less than sampling interval				(D) Misstatement as a percent of book amount* (C/A)			Should misstatement be projected? If not explain:
1	_____	_____	_____	_____	_____	_____	_____
2	_____	_____	_____	_____	_____	_____	_____
3	_____	_____	_____	_____	_____	_____	_____
TOTAL*				_____			

1. When sampling from a different population for understatement of a primary population (such as when sampling subsequent disbursements to test completeness of recorded accounts payable), in computing "Misstatement as a percent of book amount" the "Book amount" is the subsequent disbursement (not the recorded payable); the audited amount is the amount that was correctly accrued or correctly not accrued. For example, assume we find a $10,000 subsequent disbursement that was omitted improperly from accounts payable as of the balance sheet date. The "Book amount" is $10,000 and the "Audited amount" is zero; the "Misstatement as a percent of book amount" is 100%. Thus, the "Book amount" is based on the source of selection, not necessarily what is recorded in the financial statements.

2. If IDEA selects an item twice and it is misstated, include the item twice in this listing.

*Calculated amounts may be omitted if calculation done using IDEA.

Section IV (continued)

Compute projected misstatements:

(Omit steps E through H if computed by IDEA)

(E) Number of equivalent complete misstatements in sample (excluding misstatements found in 100% examined items - see Note) from column D on previous page _____

(F) Sampling interval _____

(G) Projected misstatements (ExF) _____

(H) Misstatements found in 100% examined items _____

(I) Total projected misstatement (G+H) (or from IDEA output) _____

(If from IDEA, W/P Reference to IDEA output) _____

Conclusion: Are we satisfied that book amount is fairly stated? [ ] Yes [ ] No [ ] Not enough evidence
If no or not enough evidence, what will we do?

_____

_____

_____

_____

CLASSICAL VARIABLES SAMPLING

Auditee _____

Period Ended _____

	During planning		At end of test	
	Initials	Date	Initials	Date
Prepared by	_____	_____	_____	_____
Reviewed by	_____	_____	_____	_____

SECTION I - Define objectives and method of testing

Line item: _____

Assertion: _____

Test: _____

Description of 100% examined items: _____
_____
_____

SECTION II - Define Population

Population is: _____

_____

Population size: dollars:_____
number of items: _____

Direction of Test: Starting from (source): _____
Testing to (documents to be examined): _____

When this period is less than entire period under audit or where the population being tested is less than the population in the financial statements, describe briefly (and cross-reference to) procedures to obtain satisfaction about the remainder of the population: _____

_____

_____

Steps to be satisfied that the selection is from a population equivalent to the defined population:

_____

_____

Population analyzed by:
[ ] Review of printout of population
[ ] Review of manual listing of population
[ ] IDEA stratification
[ ] Other computer-assisted method—describe:

_____

SECTION III - Determine sample size

a. Confidence Level _____%
b. Materiality (generally design) $_____
c. Precision for total population $_____
d. Strata Definitions:

Stratum	From	To	Number of items	Dollars
1				
2				
3				
4				
5				
6				
7				
8				
9				
10				
11				
12				
13				

e. Sample size based on these factors is: _____

W/P reference to:

[ ] IDEA _____
[ ] SROSTATS calculation _____
[ ] Pilot sample estimate _____

Section IV - Evaluation of substantive tests

a. Evaluation method -- W/P reference to:

[ ] IDEA _____
[ ] SROSTATS calculation _____
[ ] Spreadsheet _____

b. Estimating technique

[ ] Direct projection
[ ] Difference estimation
[ ] Separate ratio
[ ] Combined ratio
[ ] Combined Regression
[ ] Other _____

c. Point Estimate $ _____

Confidence interval From $ _____ To $ _____
At _____ % Confidence level

Conclusion: Are we satisfied that book amount is fairly stated? [ ] Yes [ ] No [ ] Not enough evidence
If no or not enough evidence, what will we do?

_____
_____
_____
_____

[This page intentionally left blank.]

495 F - MANUALLY SELECTING A DOLLAR UNIT SAMPLE

.01 Even though auditors usually use software (such as IDEA) to select a dollar-unit sample, it is helpful to understand the process for manually selecting a dollar-unit sample. To select a dollar-unit 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 calculator

c. Select and document a random start and enter as a negative number in the calculator. 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 calculator subtotals were positive for invoices #3, 10, 17, 19, and 24.]

   Do not enter into the calculator 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 calculator 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 calculator.

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, assertions, and RSSI	235
• Identify significant cycles, accounting applications, and financial management systems	240
• Identify significant provisions of laws and regulations	245
• Identify relevant budget restrictions	250
• Assess risk factors	260
• Determine likelihood of effective information system 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 information systems	320
• Identify control objectives	330
• Identify and understand relevant control activities	340
• Determine the nature, timing, and extent of control tests and of tests for systems' compliance with FFMIA requirements	350
• Perform nonsampling control tests and tests for systems' compliance with FFMIA requirements	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 generally accepted accounting principles	560
• Determine compliance with GAO/PCIE *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 financial statements, the entity's internal control, the entity's compliance with laws and regulations and the financial management systems' substantial compliance with the three FFMIA requirements, and other information (management's discussion and analysis (or the overview of the reporting entity), required supplementary information (unaudited RSSI is considered required supplementary information), and other accompanying 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.)

[This page intentionally left blank.]

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 329). 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 financial 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 financial 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. For example, the auditor might perform overall analytical procedures at the account level and roll them up to the financial statement line item to which they belong.

.04 The auditor may 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 MD&A (overview of the entity) included in the Accountability Report (annual financial statement). For example, the auditor should use the MD&A, 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 MD&A.

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 may be on a summarized level, such as the level of financial statements, or a more detailed level, as discussed in paragraph 520.03. 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, final 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 significant 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 financial statements.

[This page intentionally left blank.]

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, the overall level of audit assurance used, 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 Reviewer to determine the necessity of additional procedures.

.02 When determining whether an opinion can be expressed on the financial statements, any limitations on the nature, timing, or extent of work performed should be considered. Additional guidance on scope limitations and their impact is provided in paragraphs 580.14-.18.

[This page intentionally left blank.]

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 financial statements.

.02 Additionally, the auditor needs to consider the implications of misstatements on the following.

- The auditor's evaluation of internal control (see paragraphs 580.32-.61)

  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 consideration of the risk of material misstatement due to fraud (see paragraphs 540.18-.21)

  Consider whether the accumulated results of audit procedures and other observations would change the risk of material misstatement due to fraud identified during planning.

- The entity's compliance with laws and regulations (see paragraphs 580.62-.70)

  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.

- The auditor's evaluation of the financial management systems' substantial compliance with the three FFMIA requirements (see paragraph 580.71-.75)

  Consider whether the misstatements would have a significant impact on the auditor's conclusions with respect to the financial management systems' substantial compliance with the three FFMIA requirements.

- 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 or

- **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 financial 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, bring all misstatements to the attention of the appropriate level of management, and 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 Reviewer should review the Summary of Possible Adjustments. Per AU 312.40, the auditor may designate an amount below which misstatements need not be accumulated. This amount should be set so that any such misstatements, either individually or when aggregated with other such misstatements, would not be material to the financial statements, after the possibility of further undetected misstatements is considered.

.05 The financial 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 to be included in 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 financial statements, such as total assets or total expenditures. If so, the auditor should consider the effects on the financial statements in addition to any unadjusted misstatements when determining the appropriate type of opinion. Further guidance on evaluating estimates is provided in AU 312.36 and AU 342.

REVIEW OF MISSTATEMENTS WITH MANAGEMENT

.07 After accumulating and summarizing the adjustments, the auditor

- **must** bring all misstatements found (except those below the auditor-designated amount at which misstatements need not be accumulated) to the attention of appropriate entity management;

- **should** encourage entity management to adjust the entity's records to correct all <u>known misstatements</u>; and

- **should** encourage entity management to determine the cause of the likely misstatements and to make appropriate adjustments; unless the entity's analysis determines another adjustment is appropriate, the auditor should encourage entity management to establish valuation allowances for likely misstatements, net of known misstatements (since

the likely misstatement represents the best estimate of the correction needed).

.08 In presenting the proposed adjustments to management, the auditor should remind management that SAS 89 requires the audited entity to indicate in the management representation letter that the unadjusted misstatements, individually or in the aggregate, are not material to the financial statements taken as a whole. SAS 89 also requires that a summary of the unadjusted misstatements be attached to the representation letter. Thus, management may consider some of the same factors presented in paragraphs 540.09-.16.

CONSIDERATION OF UNADJUSTED MISSTATEMENTS

.09 If entity management declines to record adjustments for any misstatements, the auditor considers 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, following the format provided in section 595 D or equivalent. Overall guidance on evaluating misstatements is provided in AU 312.34-.40. If total unadjusted likely misstatements are material, the auditor should modify the opinion on the financial statements (see paragraph 580.22). 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. The Audit Director should be involved in the decision and review the documentation related to it. Also, the Reviewer should review and approve the documentation of the decision.

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. The Statistician should compute the combined precision for all sampling applications.

.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. The Reviewer should be consulted in considering these issues.

.13 The auditor's report addresses the fair presentation of the financial statements as a whole. When considering the effects of any unadjusted misstatements on the financial statements, the auditor should bear in mind that he/she is taking less responsibility for individual line items in the financial statements and in any combining statements and supplemental schedules than for the financial 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 financial 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 MD&A (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 financial statements of any misstatements detected in prior periods. If corrected in the current period, the auditor should record the impact on current-period financial statements in the Summary of Possible Adjustments. If uncorrected, the auditor should consider the misstatement in combination with current-period misstatements. Guidance is provided in AU 312.37.

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 financial statements. If the misstatement is considered to be material, the auditor should consult the Reviewer to determine the effects 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 financial statements.

MANAGEMENT DISAGREEMENT WITH LIKELY MISSTATEMENTS

.17 If management disagrees with the auditor's likely misstatements and if the disagreement involves amounts that are material, 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 financial statements based on his/her estimate.

- The auditor may want to increase assurance in the likely misstatements in order to convince entity management of the amount or to support the report on the financial 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 Reviewer before beginning any of these additional procedures.

- The Audit Director may decide not to expend additional resources to resolve the disagreement. If the auditor believes the estimate is sufficiently accurate, he or she would express a qualified or adverse opinion, depending on the materiality of the item to the financial statements taken as a whole. If the auditor believes the estimate is not sufficiently accurate, he or she would qualify or disclaim an opinion for a scope limitation, depending on the materiality of the item to the financial statements taken as a whole.

RECONSIDERATION OF FRAUD RISK

.18 The consideration of the risk of material misstatement due to fraud is a cumulative process that should be ongoing throughout the audit. The auditor should consider whether the audit test results indicate the need for a change in the original consideration of fraud risk made in planning (see section 260) or whether the results indicate a need for additional or different audit procedures.

.19 When audit tests identify misstatements, the auditor should consider whether these may be indicative of fraud. If the auditor determines that misstatements are or may be the result of fraud, he or she should consult with the Audit Director and the Reviewer who will determine whether to seek help from the Special Investigator Unit and/or OGC. If the effect is not material to the financial statements, the auditor should consider the

implications, especially regarding the organizational position of the individual(s) involved. If the person involved in the fraud is a relatively low-level employee, there is little significance to the audit, although the misstatement should be reported at least to the next level of management. However, if the person is of a higher level of management, even though the amount of misstatement found is immaterial, the auditor should consider whether it may indicate a more pervasive problem and should reevaluate fraud risk as well as the assessment of inherent and control risk; the assignment of personnel; and the nature, timing, and extent of substantive testing.

.20 If the misstatement is or may be the result of fraud and the effect could be material or the auditor is unable to evaluate whether the effect is material, he or she, in consultation with the issue area director, should (1) consider the implications on other aspects of the audit (see previous paragraph), (2) discuss the matter with at least the next level of entity management and with senior management, (3) consider whether to attempt to obtain additional evidence to determine whether material fraud has occurred or is likely to have occurred and the effect on the financial statements and the audit report, and (4) consider whether to advise entity management to consult with its general counsel.

.21 Fraud involving senior management and fraud that causes a material misstatement of the financial statements should be included in the audit report in the compliance section and in the report on the financial statements section if the financial statements are misstated. When the auditor identifies evidence of these cases, the Special Investigator Unit and/or OGC should be consulted. If the auditor has identified fraud risk factors that have continuing control implications, the auditor should consider whether these risk factors represent reportable conditions that should then be included in the audit report in the internal control section.

FINANCIAL MANAGEMENT SYSTEMS

.22 For audits of the CFO Act agencies and components identified by OMB in its audit guidance, the auditor should determine whether the entity's financial management systems comply substantially with the three requirements of FFMIA. Federal financial management systems requirements and the SGL at the transaction level were considered in sections 350 and 360. At this point, the auditor should reassess those preliminary conclusions and

conclude on the federal accounting standards, using the indicators referenced in OMB audit guidance, based on the results of control, compliance, and substantive testing and evaluation of misstatements found. If the auditor concludes that the systems do not comply with the requirements, he or she should report the noncompliance (see section 580).

[This page intentionally left blank.]

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-.11), and
- related party transactions (see paragraph 550.12).

INQUIRIES OF ATTORNEYS

.02 In considering any contingent liabilities or uncertainties that may affect the entity or its financial 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 and OMB audit guidance (see also section 280).

.03 The inquiries and responses should cover the entire period under audit and the subsequent period through completion of fieldwork (the date of the auditor's report). A response should be obtained from counsel at the approximate end of fieldwork. If a long period elapses from end of fieldwork 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 the audit report is issued. Such events or transactions that have a material effect on the financial statements and therefore require adjustment to or disclosure in the financial statements are referred to as subsequent events. AU 560 provides guidance on determining whether a particular subsequent event requires adjustment to or disclosure in the financial statements (see also section 1005).

.05 To identify subsequent events that would require either adjustment to or disclosure in the financial statements, the auditor should follow the procedures described in AU 560.10-12 (see also section 1005). These procedures should be performed at or near the completion of fieldwork. If a long period elapses from end of fieldwork 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. AU 333.06, AT 400.42, and AU 801.07 provide examples of the written representations usually obtained from management (see also sections 1001 and 1001 A). Additionally, the auditor may request representations on other matters.

.08 Federal government auditors should obtain further representations from management in addition to those required by generally accepted auditing standards. These are management assertions about the effectiveness of internal control and about substantial compliance of financial management systems with the three requirements of FFMIA.

.09 If management refuses to provide the requested written representations, the auditor considers this a limitation on the audit scope and modifies the report (see paragraphs 580.14-.18). In these situations, the auditor should consider the reliability of other representations received from management during the audit.

.10 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.

.11 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

.12 The auditor should be aware of the possible existence of relationships with related parties and material related party transactions that could affect the financial statements. AU 334 provides guidance on identifying related parties, examining related party transactions, and considerations for disclosure (see also section 1006).

[This page intentionally left blank.]

560 - DETERMINE CONFORMITY WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

.01 Generally accepted accounting principles (GAAP) for federal government entities are developed by the Federal Accounting Standards Advisory Board (FASAB), an entity created by GAO, OMB, and Treasury. FASAB was recognized by the American Institute of Certified Public Accountants (AICPA) as the body to establish GAAP for federal governmental entities under Rule 203, "Accounting Principles," of the AICPA's *Code of Professional Conduct*. Pursuant to the resolution adopted by the AICPA Council on October 19, 1999, Statements of Federal Financial Accounting Standards (SFFAS) issued by FASAB are recognized as GAAP for the applicable federal governmental entities. FASAB develops federal accounting concepts or standards and transmits them to the Comptroller General, the Secretary of the Treasury, and the Director of OMB (the three principals). The accounting concepts or standards become final 90 days after transmittal, provided no principal advises FASAB of an objection during the 90 days. The concepts or standards are then issued by FASAB.

.02 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 "a" unless that item is silent about a particular topic. In that case, the entity is to use the guidance in item "b," unless it also does not address the topic, and so on to item "c," or "d," until guidance addressing the topic is found. This hierarchy is recognized by the AICPA as GAAP for applicable federal entities, according to SAS 91:

a. FASAB Statements and Interpretations plus AICPA and FASB pronouncements if made applicable to federal governmental entities by a FASAB Statement or Interpretation.

b. FASAB Technical Bulletins and the following pronouncements if specifically made applicable to federal governmental entities by the AICPA and cleared by FASAB: AICPA Industry Audit and Accounting Guides and AICPA Statements of Position.

c. AICPA AcSEC Practice Bulletins if specifically made applicable to federal governmental entities and cleared by FASAB and Technical Releases of its Accounting and Auditing Policy Committee.

d. Implementation guides published by FASAB staff and practices that are widely recognized and prevalent in the federal government.

.03 In the absence of a pronouncement in the above hierarchy, the auditor may consider other accounting literature, including FASAB Concepts Statements; pronouncements in categories "a" through "d" above when not specifically made applicable to federal governmental entities; FASB and GASB Concepts Statements; GASB Statements, Interpretations, and Technical Bulletins; AICPA Issues Papers; International Accounting Standards of the International Accounting Standards Committee; pronouncements of other professional associations or regulatory agencies; AICPA *Technical Practice Aids*; and accounting textbooks, handbooks, and articles.

.04 Entities are required to summarize the significant accounting policies used in the notes to the principal statements.

.05 The auditor should review the financial statements for conformity with GAAP and should identify any instances of nonconformity. Such nonconformity may include incomplete disclosure or use of an accounting principle that is contrary to GAAP. A Checklist for Reports Prepared Under the CFO Act is in section 1004 (Part II) for reviewing the financial statements for appropriate and adequate disclosure in accordance with GAAP.

.06 The auditor should consider the impact of nonconformity with GAAP on the financial statements and should determine the effects, if any, on the auditor's report (see paragraph 580.22).

570 - DETERMINE COMPLIANCE WITH GAO/PCIE *FINANCIAL AUDIT MANUAL*

.01 The auditor must determine whether the audit was conducted in accordance with GAGAS, OMB audit guidance, and GAO/PCIE financial audit methodology. The auditor should use the audit completion checklist included in section 1003 (Part II) for determining and documenting compliance.

[This page intentionally left blank.]

580 - DRAFT REPORTS

.01 At the conclusion of the audit, the auditor finalizes the draft of the auditor's report(s), which includes the auditor's conclusions on

- the financial statements (see paragraphs 580.10-.31);
- internal control (see paragraphs 580.32-.61);
- compliance with laws and regulations (see paragraphs 580.62-.70);
- whether the financial management systems substantially comply with the requirements of FFMIA: federal financial management systems requirements, federal accounting standards (GAAP), and the SGL at the transaction level (see paragraphs 580.71-.75); and
- the MD&A (see requirements in SFFAS No. 15) and other information included in the Accountability Report (including RSSI) (see paragraphs 580.76-.81).

.02 The auditor's report should clearly identify the entity audited, the Accountability Report on which the auditor is reporting, and the period covered by the Accountability Report.

.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 example unqualified auditor's report on the Accountability Report is presented in section 595 A. The auditor may use another reporting format, such as issuing separate reports on the financial statements (see AU 508) and on internal control and compliance (see AICPA *Audit and Accounting Guide: Audits of State and Local Governmental Units* or OMB audit guidance) and should document the reasons for deviations from the language required by the professional standards. GAO auditors also should document the reasons for deviations from the example reporting format or language in sections 595 A and/or B. The example report includes the following sections:

- Introduction;
- Significant Matters (when applicable);
- Conclusions on
  - financial statements,
  - internal control,
  - compliance with laws and regulations and FFMIA requirements, and
  - 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 financial statements, internal control, and compliance with laws and regulations and FFMIA requirements.

.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, .34-.36, and .68-.70);

- uncertainties for which the auditor disclaimed an opinion (paragraph 580.19);

- material departures from generally accepted accounting principles (paragraph 580.22);

- material weaknesses in internal control (including performance measures controls) or other weaknesses that the auditor has decided to describe in the audit report (paragraphs 580.51-.55);

- material conflicts between the Summary of Management's Report on Internal Controls prepared under FMFIA and the results of the auditor's evaluation of internal control (paragraph 580.61);

[1] The auditor may include certain other matters in this section as discussed in paragraphs 580.26-.27.

- instances of noncompliance that are reportable under GAGAS or OMB audit guidance, that is, any that are not clearly inconsequential (paragraphs 580.66-.67);

- instances of lack of substantial compliance with the three requirements of FFMIA (paragraphs 580.72-.74);

- material inconsistencies between other information (MD&A, required supplementary information, including RSSI, and other accompanying information) and the financial statements, or material nonconformity of the other information with OMB guidance for such information (paragraphs 580.76-.80); 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.

This section should be phrased similar to an executive summary. Matters should be described in nontechnical 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 financial statements, internal control, compliance with laws and regulations, financial management systems' substantial compliance with the three requirements of FFMIA, 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 control, and a statement that the audit was performed in accordance with GAGAS and OMB's audit guidance.

.09 The remainder of this section provides guidance on forming conclusions on the financial statements, internal control, compliance with laws and regulations, financial management systems' substantial compliance with the three requirements of FFMIA, and other information.

- Example report wording of an unqualified auditor's report on the Accountability Report 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.

FINANCIAL STATEMENTS

.10 Under GAAS, the fourth standard of reporting on financial statements follows (see AU 508.04):

> "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 financial statements, the auditor considers the following areas: (1) audit scope, (2) uncertainties, (3) consistency, and (4) departures from GAAP. Each of these areas and their effects on the report are discussed below.

.12 The auditor considers these four areas and the results of all audit procedures performed to determine if an opinion can be expressed on the financial 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.

.13 The auditor should formulate the type of report on the financial 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 audit guidance. 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 financial 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 determines the appropriate type of opinion. Three areas that the auditor should consider when forming the opinion are uncertainties, consistency, and departures from GAAP.

Uncertainties

.19 Uncertainties are matters affecting the financial 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 (amended by SFFAS No. 12), 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 580.28-.29 and .31 (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 580.28-.29 and .30, respectively (see AU 508.45-.49).

Consistency

.20 The auditor is concerned with comparability between the financial statements for all periods presented or with the prior period if only 1 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 420.22 -.25. Guidance on the auditor's consideration of accounting and other changes that may affect the consistency of the financial statements may be found in AU 420. Inconsistencies may result in an explanatory paragraph or departure from GAAP. Guidance on reporting on a lack of consistency is provided in AU 508.16-.18.

.21 If the entity has a change in accounting principles when it first adopts FASAB standards, the auditor should include a paragraph on consistency in

the audit report, regardless of whether or not the financial statements of the previous period are presented. The paragraph should state that the entity adopted SFFAS No. X, as discussed in note XX. The SFFASs generally specify what disclosures are required upon adoption.

Departure from GAAP

.22 The auditor must consider whether the financial statements are materially affected by a departure from GAAP. If such a departure exists, the auditor should determine the extent of the effects of the departure on the financial 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 financial 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 financial statements, a departure from GAAP may not result in a qualified or adverse opinion (see AU 508.14 -.15).

Types of reports

.23 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 in paragraphs 580.24-.31.

Unqualified Opinion

.24 In an unqualified opinion on the financial statements, the auditor concludes that the financial 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, in conformity with generally accepted accounting principles.

.25 If, in the auditor's judgment, he/she cannot make this conclusion (for reasons discussed in paragraphs 580.14-.22) the auditor's report on the financial 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

.26 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 the 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 financial 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 financial statements. (See AU 508.68-.69 and .72-.74.)
- Supplementary information required by FASAB or OMB has been omitted, the presentation of such information departs materially from FASAB or OMB guidelines or is materially inconsistent with information in the financial 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 FASAB 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).

.27 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 not required, an explanatory paragraph may be added when the financial 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

.28 A qualified opinion states that except for the effects of the matter to which the qualification relates, the financial statements present fairly, in all material respects, the assets, liabilities, 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 GAAP. Guidance on qualified opinions is provided in various paragraphs of AU 508.

.29 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 GAAP had a material effect on the financial statements but has decided not to express an adverse opinion (see paragraph 580.22).

AU 508.21 provides guidance on qualified opinions. Section 595 B provides guidance on specific report modifications for qualified opinions.

Adverse Opinion

.30 An adverse opinion states that the financial 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 generally accepted accounting principles. This type of opinion is expressed on the financial statements taken as a whole when there are material departures from GAAP

as discussed in paragraph 580.22. Guidance on adverse opinions is provided in AU 508.58-.60. Section 595 B provides specific report modifications for adverse opinions.

Disclaimer Report

.31 In a disclaimer report, the auditor does not express an opinion on the financial 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 involving a scope limitation, 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 CONTROL

.32 Federal financial auditors may take one of two different approaches to reporting on internal control: (1) management provides an assertion about the effectiveness of its internal control and the auditor expresses an opinion on internal control (see paragraphs 580.38-.48)[2] or (2) the auditor reports weaknesses found but does not give an opinion (see paragraphs 580.49-.50). (OMB audit guidance requires management to include representations about internal control in the management representation letter in either case.) GAO auditors generally express an opinion on internal control. In either case, the auditor considers whether internal control is sufficient to meet the following control objectives insofar as those objectives pertain to preventing or detecting misstatements, losses, or noncompliance that would be material in relation to the financial statements:

- Reliability of financial reporting—transactions are properly recorded, processed, and summarized to permit the preparation of the financial statements and RSSI in accordance with GAAP, and assets are

[2] The auditor may express an opinion on management's assertion if he or she finds no material weaknesses in internal control.

safeguarded against loss from unauthorized acquisition, use, or disposition.

- Compliance with applicable laws and regulations—transactions are executed in accordance with laws governing the use of budget authority and other laws and regulations that could have a direct and material effect on the financial statements or RSSI and any other laws, regulations, and governmentwide policies identified by OMB in its audit guidance.

The auditor also should report any reportable conditions detected in performance measures controls but does not need to express an opinion on whether internal control is sufficient to meet the objective that data supporting performance measures are properly recorded, processed, and summarized to permit preparation of performance information in accordance with criteria stated by management.

Classifying Control Weaknesses

.33 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 one or more of the internal control components does not reduce to a relatively low level the risk that misstatements, whether caused by errors or fraud, losses, or noncompliance in amounts that would be material in relation to the financial statements, RSSI, or 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.[3]

- **Reportable conditions** are 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 control, which could adversely affect the entity's ability to meet the internal control objectives described in the report.

[3] This definition is used to determine whether a material weakness exists. Abbreviated language is used in an opinion report (see section 595 A).

.34 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 control and reporting findings, as discussed in paragraphs 580.42-.48 and 580.51-.58. Additional guidance on classification of internal control weaknesses is provided in AU 325.

.35 OMB has provided guidance, supplementing Circulars A-123 (June 21, 1995) and A-127 (July 23, 1993 and revisions in Transmittal Memorandum No. 2, dated June 10, 1999), 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 control (see paragraph 580.33).

.36 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).

.37 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.

Opinion on Internal Control

.38 The auditor's evaluation of the entity's internal control and the results of other audit procedures form the basis for the auditor's opinion on internal control. 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 580.39-.49). The auditor should communicate any identified internal control weaknesses (including weaknesses in operations controls), as discussed in paragraphs 580.51-.58, and consider the effects of such weaknesses on other reports prepared by the entity (paragraph 580.60).

Scope of Procedures

.39 To express an unqualified opinion on internal control, the auditor must have an assertion from management about the effectiveness of internal control and 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 internal control. Scope restrictions may be imposed by the entity or may be due to other circumstances. 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 control. However, if a significant scope restriction is imposed by the entity, the auditor should disclaim an opinion.

.40 When determining the severity of a scope limitation on internal control, the auditor should consider the control objectives listed in the report--financial reporting, including safeguarding assets, and compliance with laws and regulations. If the scope of work on internal control relevant to one of these objectives is limited, the auditor may need to qualify or disclaim the opinion on internal control regarding that objective. Also, the auditor should determine whether that limitation affects his/her ability to opine on the other objective. If a scope limitation is encountered for a control objective, the auditor should exercise judgment in determining if it is appropriate to give an <u>unqualified</u> opinion on internal control over either objective. In the case of a scope limitation, the auditor should review the guidance in AT 400.55-.58 and consult with the Reviewer to determine the appropriate type of opinion. Section 595 B contains example language for situations in which (1) the auditor is satisfied that the scope limitation affects only one control objective <u>and</u> that it is considered appropriate to give an opinion on internal control over the other objective and (2) the auditor believes a disclaimer report on internal control, as a whole, is appropriate due to a scope limitation.

.41 If the auditor has determined that an opinion can be expressed on one or both of the control objectives, the type of opinion to be given depends on whether any internal control weaknesses are identified and the significance of such weaknesses. In concluding as to the effectiveness of internal control, 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 control is discussed below. If no material weaknesses or other reportable conditions are identified, the auditor concludes that internal control is effective in meeting the control objectives.

Effects of Control Weaknesses on the Auditor's Conclusion as to the Effectiveness of Internal Control

.42 Based on the types of weaknesses noted, the auditor should conclude as to the effectiveness of internal control as of the end of the audit period, as discussed in paragraphs 580.43-.47. Management also concludes as to the effectiveness of internal control in deciding what assertion to make.

Material weaknesses

.43 If material weaknesses exist at the end of the audit period, the auditor should conclude that the entity's internal control is 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 internal control is effective for that objective. If a material weakness relates only to one control objective, the auditor should determine whether internal control is effective in achieving the other control objective. The auditor should exercise judgment when concluding that the effects of a material weakness are isolated to one control objective.

.44 The auditor also should exercise judgment in deciding whether it is appropriate in the circumstances to conclude that "except for" a material weakness, internal control is effective for the objective. Management should exercise judgment in deciding what assertion to make about the effectiveness of internal control. By definition, a material weakness is a very significant condition (see paragraph 580.33) that could allow misstatements, losses, or noncompliance 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 a material weakness, the weakness is not severe enough to judge that internal control for that objective is ineffective, he or she may conclude that internal control 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 internal control to be effective for that

objective, even "except for" the material weakness(es), he or she should conclude that internal control 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 less significant or to one of the more significant aspects of the entity, 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.

.45 If a material weakness is presented in a report that also includes an unqualified opinion on the financial 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. Example report modifications for material weaknesses are provided in section 595 B.

Reportable conditions other than material weaknesses

.46 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

.47 Weaknesses that do not meet the criteria for reportable conditions (paragraph 580.33) do not affect the auditor's conclusion as to the effectiveness of internal control. They may be reported in a management letter or orally.

Type of Opinion

.48 As described in paragraphs 580.39-.41, 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 internal control 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 control and there are no material weaknesses or other reportable conditions in internal control, the opinion on internal control is unqualified (see section 595 A).

- If the auditor and management agree as to the effectiveness of internal control and there are no material weaknesses in internal control, but there is(are) other reportable condition(s), the auditor modifies the report on internal control by stating that internal control is effective but 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 control and there <u>are</u> material weaknesses in internal control, the auditor modifies the opinion on internal control by (1) referring to the material weakness(es) noted in management's assertion (which states that internal control with respect to one or both of the internal control objectives--financial reporting, including safeguarding, or compliance--is either effective "except for" the material weakness (qualified opinion) or ineffective (adverse opinion)) and (2) describing the material weakness(es). (See section 595 B.)

- If the auditor and management disagree as to the effectiveness of internal control, either because (1) management does not agree that material weakness(es) exist or (2) management does not appropriately modify its assertion about the effectiveness of internal control in light of the material weakness(es), the auditor's opinion is also adverse. (The existence of a material weakness precludes management from asserting that its internal control is effective for that objective.) Thus, an adverse opinion is appropriate if management states that internal control is effective "except for" the material weakness(es) when, in the auditor's

judgment, the material weakness(es) is(are) so severe that internal control is ineffective (see paragraph 580.44 and section 595 B).

The auditor should consult with the Reviewer on the opinion on internal control, especially in instances where he or she concludes that a material weakness is isolated to one control objective or that internal control is effective "except for" a material weakness.

Nonopinion Report

.49 If the purpose of the audit is not to render an opinion on internal control, the auditor should report material weaknesses and other reportable conditions in internal control, or state that no material weaknesses were found. (See sections 595 A and/or B.) If, in the auditor's judgment, material weaknesses were so significant that the auditor concludes internal control was ineffective for one or more objectives, he or she may state that conclusion in the report. (See section 595 B.)

.50 The AICPA, in SAS No. 87, states that a report on internal control in which no opinion is issued is a by-product report, a report that provides a limited degree of assurance about internal control. When no opinion is issued, the report on internal control is not the primary objective of the engagement. SAS 87 states that the auditor should indicate the intended use of the internal control report because of the potential for misunderstanding related to a by-product report's limited degree of assurance. Because the distribution of government audit reports is not restricted, the reports should explain their limitations. (See section 595 A where, in a footnote explaining changes for a non-opinion internal control section, the example report cautions the reader that the internal control testing performed may not be sufficient for other purposes.)

Where to Report Control Weaknesses

.51 The means of communicating weaknesses in internal control depends on the type of weakness, as discussed in paragraph 580.33. Each type of weakness is discussed in paragraphs 580.52-.55 below.

Reportable conditions (including material weaknesses)

.52 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 Accountability Report. 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 combined with related matters to the extent possible as discussed in paragraph 580.06. If management's assertion about the effectiveness of internal control is printed with the audit report, the auditor's report should refer to the discussion of the material weakness (or other reportable condition) in management's assertion.

.53 The significant matters section of the auditor's report on the Accountability Report 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. If more complete information concerning the weakness is provided in other reports issued prior to or at the same time as the auditor's report on theAccountability Report, a reference to such other reports (such as date and title or report number) generally should be included in the auditor's report on the Accountability Report.

.54 Reportable conditions not considered to be significant matters individually, as described in paragraph 580.52, should be listed in the significant matters section or in the internal control 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 or report on internal control generally 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.

.55 The auditor may report weaknesses that do not meet the criteria for reportable conditions in a management letter (including the elements that are reported in the management letter as discussed in paragraph 580.57), 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

.56 Control weaknesses identified by the auditor are considered to be findings. The "yellow book" (paragraph 6.49) 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).

.57 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 Accountability 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 prompt 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.

.58 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

.59 To communicate audit findings promptly, the auditor should consider issuing reports and/or management letters during the audit. In such instances, the audit report on the Accountability Report describes significant matters and the general nature of other reportable conditions (as discussed in paragraphs 580.52-.54) and refers to such reports and/or management letters. The reference generally should be sufficient to allow the reader to request these reports and/or management letters. For example, titles and dates or accession numbers generally should be included.

.60 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 financial statements.

Reporting on management's FMFIA reports

.61 In the internal control section of the auditor's report, the auditor considers whether material weaknesses, other reportable conditions, or financial management systems' nonconformances identified during the audit were identified in management's FMFIA report. The auditor should investigate any material weaknesses, other reportable conditions, or systems' nonconformances 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 or systems' nonconformances that should have been reported under FMFIA (see paragraphs 580.35-.37), he or she should refer to 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 or systems' nonconformances, perhaps due to a lack of training or understanding or to limitations in the scope of the FMFIA process. (For example, certain areas were not reviewed annually or certain types of controls or systems were not reviewed.)

- Management did not recognize that identified weaknesses were FMFIA material weaknesses or systems' nonconformances.

- 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 or systems' nonconformances of branches or agencies).

COMPLIANCE WITH LAWS AND REGULATIONS

.62 The auditor reports on the results of compliance testing and on compliance matters (including fraud—see section 540) coming to his or her attention during procedures other than compliance tests. The manner in which noncompliance is reported depends on the significance of the noncompliance and whether such noncompliance is material to the financial statements, as described below. The auditor should consult with OGC regarding conclusions on the entity's compliance with laws and regulations. For certain laws, such as the Budget and Accounting Procedures Act, the CFO Act, FMFIA, and the Single Audit Act, failure to administratively follow the law (e.g., not filing the CFO Act report on time) may be more properly reported as an internal control problem in the internal control section of the audit report, rather than as noncompliance.

.63 The following definitions and guidelines should be used for classifying noncompliance detected during the audit.

- **Reportable noncompliance** includes all matters coming to the auditor's attention except those that in the auditor's judgment, are clearly inconsequential.

- **Material noncompliance** is reportable noncompliance in which a failure to comply with laws or regulations results in misstatements that are material to the financial statements. Any instances of material noncompliance should be described in the significant matters section of the audit report.

.64 Reportable noncompliance, other than material noncompliance, should be described in the significant matters section of the auditor's report 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 or in the compliance section of the report. Related instances of noncompliance should be combined. Such noncompliance may 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 Accountability Report. To the extent that any such noncompliance contributes to significant matters, it should be described in conjunction with the related significant matter.

.65 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

.66 The auditor states directly whether 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 580.64-.65.

.67 The AICPA, in SAS No. 87, states that a report on compliance with laws and regulations in which no opinion is issued is a by-product report, a report that

provides a limited degree of assurance about compliance. When no opinion is issued, the report on compliance is not the primary objective of the engagement. SAS 87 states that the auditor should indicate the intended use of the compliance report because of the potential for misunderstanding related to a by-product report's limited degree of assurance. Because the distribution of government audit reports is not restricted, the reports should explain their limitations. (See section 595 A in the objectives, scope, and methodology section).

Scope of procedures

.68 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, he or she 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.

.69 If the scope limitation is so significant that the auditor believes that any statement could be misleading, he or she 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.

.70 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 Reviewer and OGC concerning the appropriate reporting of such weaknesses and compliance tests.

FINANCIAL MANAGEMENT SYSTEMS

.71 FFMIA requires the auditor to report whether the financial management systems of CFO Act agencies or the components designated by OMB comply substantially with three federal financial management systems

requirements. These requirements, also required by OMB Circular A-127, are

- federal financial management systems requirements, chiefly found in the JFMIP functional requirements documents (listed in OMB audit guidance);
- applicable federal accounting standards, which are now recognized as GAAP (see section 560); and
- the SGL at the transaction level.

Reporting on Substantial Compliance with FFMIA Requirements

.72 In the compliance section of the audit report, the auditor states directly whether any instances of lack of substantial compliance with the FFMIA requirements were detected during testing, based on the indicators referenced in OMB audit guidance. This type of direct statement is illustrated in section 595 A for a situation in which testing disclosed no instances of lack of substantial compliance. If lack of substantial compliance is noted, the statement should be modified as shown in section 595 B, and the instances of lack of substantial compliance should be discussed in the significant matters section of the audit report on the annual financial statements. Frequently, lack of substantial compliance is related to material weaknesses or other reportable conditions in internal control. If so, the discussion should be combined in the significant matters section to avoid redundancy.

.73 If the entity's systems did not substantially comply with the requirements, the auditor is required by FFMIA to identify the entity or organization responsible for the systems found not to comply; include pertinent facts, including nature and extent of the noncompliance, primary reason or cause, and any relevant comments from management or responsible employees; and make recommendations of remedial actions and time frames for implementing the recommendations. This information also should be included in the significant matters section and/or a recommendation section, if either is used.

.74 The auditor may opine on whether the entity's financial management systems substantially comply with the FFMIA requirements. Management

would give the auditor an assertion with respect to the substantial compliance of its financial management systems with the FFMIA requirements. This may be in the representation letter (see section 1001) or in a separate report that could be included with the audit report. Guidance on this type of reporting is in AT 100.

Scope of Procedures

.75 If the auditor is unable to perform all the procedures considered necessary, as discussed in section 350, the scope of the audit is restricted. Generally, if the scope of the audit is restricted, the auditor reports that the financial management systems are not in substantial compliance with FFMIA requirements. (See section 595 B.)

OTHER INFORMATION IN THE ACCOUNTABILITY REPORT

.76 As discussed in OMB Bulletin, *Form and Content of Agency Financial Statements*, certain other information is to be included in the annual financial statement. This information consists of MD&A (the overview of the reporting entity), required supplementary information including RSSI, and other accompanying information.

.77 GAAP require the reporting of certain RSSI: stewardship property, plant, and equipment (PP&E) and its condition (reported in units, including heritage assets, national defense PP&E, and stewardship land); stewardship investments (including nonfederal physical property, such as highways; human capital, such as expenditures for training and education; and research and development); risk-assumed information (such as pension and deposit insurance projections); and social insurance information. OMB and GAO, which are responsible for determining audit scope related to this information, do not require RSSI to be audited. RSSI presented should be marked "unaudited."

.78 As this information is "required supplementary information," the auditor should apply procedures consistent with AU 558. As discussed in AU 558, the auditor should compare the consistency of the information with the financial statements and should discuss the methods of measurement and presentation with entity officials.

.79 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. (Although AU 558.08 requires reporting on the other information only if material inconsistencies or nonconformances with OMB guidance are found, OMB audit guidance requires the auditor to report based on AU 551.15.) 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 refer to the discussion in the significant matters section as illustrated in section 595 B.

.80 The auditor should also consider whether circumstances that resulted in modification of the auditor's report, such as a scope limitation or departure from GAAP, 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.

.81 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, the auditor should 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, the auditor should 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.

590 - DOCUMENTATION

.01 The auditor should document the nature and extent of work performed in the reporting phase and the 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 Accountability Report with the financial 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 that summarizes the audit results and demonstrates the adequacy of the audit procedures and the reasonableness of the conclusions on the financial statements, internal control, the entity's compliance with laws and regulations, substantial compliance of the financial management systems with the FFMIA requirements, MD&A (the overview of the entity), required supplementary information (including RSSI), and other accompanying 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, risk assessment, communication, and monitoring or inherent or control risks and significant revisions of audit procedures;

- additional fraud risk factors or other conditions (beyond those considered in planning—section 260) identified during the audit that caused the

auditor to believe that an additional response was required and any further response that the auditor concluded was appropriate;

- 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 financial statements, internal control, compliance with laws and regulations, the systems' substantial compliance with FFMIA requirements, MD&A, required supplementary information (including RSSI), and other accompanying information;

- the auditor's conclusions on whether the audit evidence obtained supports the conclusions on the financial statements, internal control, compliance with laws and regulations, the systems' substantial compliance with FFMIA requirements, MD&A, required supplementary information (including RSSI), and other accompanying information;

- the auditor's conclusion on whether the audit was done in compliance with GAGAS, OMB audit guidance, and the GAO/PCIE *Financial Audit Manual* and whether the report is appropriate;

- the auditor's conclusion on whether the entity's financial statements comply with generally accepted accounting principles;

- significant subsequent events, if any;

- the Summary of Unadjusted Misstatements;

- a summary of internal control weaknesses and a comparison of those the auditor found to the weaknesses reported in management's assertion about the effectiveness of internal control;

- a summary of instances of noncompliance with laws and regulations;

- a summary of instances of lack of substantial compliance with FFMIA requirements; 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 persons from whom the data were obtained, if applicable; and the source of the information (e.g., 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 judgment.

- **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 Control

.05 The basis for considering internal control weaknesses as material weaknesses, other reportable conditions, or as not reportable, 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 control 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.

Reporting Lack of Substantial Compliance With FFMIA Requirements

.07 The basis for considering whether noncompliances with FFMIA requirements represent lack of substantial compliance should be documented in the workpapers.

595 A - EXAMPLE AUDITOR'S REPORT - UNQUALIFIED

In our audit of [name of entity] for fiscal year [year], we found

- the financial statements are presented fairly in conformity with generally accepted accounting principles,
- [entity] had effective internal control over financial reporting (including safeguarding assets) and compliance with laws and regulations,[1] and
- no reportable noncompliance with laws and regulations we tested and no instances in which [entity's] financial management systems did not substantially comply with the requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA).

The following sections discuss in more detail (1) these conclusions and our conclusions on Management's Discussion and Analysis and other supplementary information and (2) the scope of our audit.

Opinion on Financial Statements

The financial statements including the accompanying notes present fairly, in all material respects, in conformity with generally accepted accounting principles (United States of America), [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)[2] as of September 30, 20XX and for the year then ended.

---

1 If the auditor is not expressing an opinion on internal control, the following should replace the second bullet: "no material weaknesses in internal control over financial reporting (including safeguarding assets) and compliance with laws and regulations and its operation, and"

2 This list assumes the entity follows GAAP issued by FASAB. If the entity follows GAAP issued by FASB (government corporations and others such as the U.S. Postal Service), modify the list accordingly.

Opinion on Internal Control[3]

[Entity] maintained in all material respects effective internal control over financial reporting (including safeguarding assets) and compliance as of [end of fiscal year] that provided reasonable assurance that misstatements, losses, or noncompliance material in relation to the financial statements or to stewardship information would be prevented or detected on a timely basis. Management's assertion was based on criteria established under the Federal Managers' Financial Integrity Act of 1982 and the Office of Management and Budget (OMB) Circular A-123, *Management Accountability and Control* [or other criteria].

Compliance With Laws and Regulations and FFMIA Requirements

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 (United States of America) or OMB audit guidance. Our tests disclosed no instances in which

---

[3] If the auditor is not expressing an opinion on internal control, this section should be replaced with the following:

"Consideration of Internal Control

"We considered internal control over financial reporting and compliance.

"We do not express an opinion on internal control over financial reporting and compliance because the purpose of our work was to determine our procedures for auditing the financial statements and to comply with OMB audit guidance, not to express an opinion on internal control. However, for the controls we tested, we found no material weaknesses in internal control over financial reporting (including safeguarding assets) and compliance and its operation. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that errors, fraud, or noncompliance 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."

[entity's] financial management systems did not substantially comply with the following requirements of FFMIA: (1) federal financial management systems requirements, (2) federal accounting standards, and (3) the *U.S. Government Standard General Ledger* at the transaction level. 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

Management's Discussion and Analysis, required supplementary information (including stewardship information), and other accompanying information contain a wide range of data, some of which are not directly related to the financial statements. We do not express an opinion on this information. However, we compared this information for consistency with the financial 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 financial statements or nonconformance with OMB guidance.

Objectives, Scope, and Methodology

Management is responsible for (1) preparing the financial statements in conformity with generally accepted accounting principles, (2) establishing, maintaining, and assessing internal control to provide reasonable assurance that the broad control objectives of the Federal Managers' Financial Integrity Act of 1982 are met, and (3) complying with applicable laws and regulations and FFMIA requirements.

We are responsible for obtaining reasonable assurance about whether (1) the financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles and (2) management maintained effective internal control, the objectives of which are the following:[4]

[4] If the auditor is not expressing an opinion on internal control, delete the numbers in parentheses, put a period after "generally accepted accounting principles," and delete the rest of the sentence including the two bullets.

- Financial reporting: Transactions are properly recorded, processed, and summarized to permit the preparation of financial statements and stewardship information in conformity with generally accepted accounting principles, and assets are safeguarded against loss from unauthorized acquisition, use, or disposition.

- Compliance with laws and regulations: Transactions are executed in accordance with laws governing the use of budget authority and with other laws and regulations that could have a direct and material effect on the financial statements and any other laws, regulations, and governmentwide policies identified by OMB audit guidance.

We are also responsible for[5] testing compliance with (1) selected provisions of laws and regulations that have a direct and material effect on the financial statements, (2) laws for which OMB audit guidance requires testing, and (3) FFMIA requirements. We are also responsible for performing limited procedures with respect to certain other information appearing in the Accountability Report.

In order to fulfill these responsibilities, we (1) examined, on a test basis, evidence supporting the amounts and disclosures in the financial statements, (2) assessed the accounting principles used and significant estimates made by management, (3) evaluated the overall presentation of the financial statements, (4) obtained an understanding of internal control related to financial reporting (including safeguarding assets), compliance with laws and regulations (including execution of transactions in accordance with budget authority), and performance measures reported in Management's Discussion and Analysis of the Accountability Report, (5) tested relevant internal controls over financial reporting (including safeguarding assets), and compliance, and evaluated the design and operating effectiveness of internal control, (6) considered the process for evaluating and reporting on internal control and financial management systems under the Federal Managers' Financial Integrity Act of 1982, (7) tested compliance with selected provisions of the following laws and regulations [list laws and regulations], and (8) tested whether [entity's] financial management systems

[5] If the auditor is not expressing an opinion on internal control, insert the following after the "for." "obtaining a sufficient understanding of internal control over financial reporting and compliance to plan the audit and for".

substantially comply with FFMIA requirements, using the implementation guidance in OMB audit guidance.

We did not evaluate all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982, such as those controls relevant to preparing statistical reports and ensuring efficient operations. We limited our internal control testing to controls over financial reporting and compliance. Because of inherent limitations in internal control, misstatements due to error or fraud, losses, or noncompliance 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.[6]

We did not test compliance with all laws and regulations applicable to [entity]. We limited our tests of compliance to those laws and regulations required by OMB audit guidance that we deemed applicable to the financial statements for the fiscal year ended [date]. We caution that noncompliance may occur and not be detected by these tests and that such testing may not be sufficient for other purposes.

We performed our work in accordance with generally accepted government auditing standards (United States of America) and OMB audit guidance.

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.

[6] If the auditor is not expressing an opinion on internal control, add at the end of this paragraph, "In addition, we caution that our internal control testing may not be sufficient for other purposes."

[This page intentionally left blank.]

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 Accountability Report (annual financial statement) illustrated in section 595 A for each of the situations listed below.

	Page
Situations relating to the financial statements:	
1. Scope limitation resulting in a qualified opinion on the financial statements	595 B-3
2. Scope limitation resulting in a disclaimer of an opinion on the financial statements	595 B-3
3. Uncertainty resulting in the addition of an explanatory paragraph	595 B-4
4. Lack of consistency in the application of accounting principles resulting in the addition of an explanatory paragraph	595 B-4
5. Departure from generally accepted accounting principles resulting in a qualified opinion on the financial statements	595 B-5
6. Departure from generally accepted accounting principles resulting in an adverse opinion on the financial statements	595 B-5
Situations relating to internal control:	
7. Scope limitation resulting in a disclaimer of opinion on internal control	595 B-6
8. Scope limitation resulting in a qualified opinion on internal control	595 B-7
9. Material weaknesses in internal control	595 B-9
10. Reportable conditions (other than material weaknesses) in internal control	595 B-12
11. The purpose was not to give an opinion on internal and other reportable conditions were found	595 B-14
12. The purpose was not to give an opinion on internal control and one or a few material weaknesses were found	595 B-16

13. The purpose was not to give an opinion on internal control and many material weaknesses were found 595 B-18

Situations relating to compliance with laws and regulations and FFMIA requirements:

14. Scope limitation—some laws and regulations could not be tested 595 B-20

15. Scope limitation—all laws and regulations could not be tested—disclaimer 595 B-21

16. Material noncompliance with laws and regulations 595 B-22

17. Reportable noncompliance (other than material noncompliance) with laws and regulations 595 B-23

18. Lack of financial management systems' substantial compliance with FFMIA requirements 595 B-24

Situations relating to the consistency of other information in the Accountability Report (management' discussion and analysis (or overview), required supplementary information (including stewardship information), and other accompanying information):

19. Material inconsistency between other information and the principal statements 595 B-26

20. Nonconformance of other information with OMB guidance 595 B-27

21. Any situation that caused the auditor to modify the report on the financial statements, internal control, or compliance with laws and regulations that also affects other information 595 B-28

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 financial statements was not available because of limitations on the scope of our work. Otherwise, we found the financial statements are presented fairly in conformity with generally accepted accounting principles."	Describe significant limitations on the scope of the work.	"Qualified Opinion on Financial Statements "Because of the limitation on the scope of our work described above, we cannot determine if the financial statements' presentation of [identify account(s) affected by the scope limitation] is free of material misstatement. Otherwise, the financial statements including the accompanying notes present fairly ..."	After the last sentence add: "We considered the limitations on the scope of our work in forming our conclusions."
2. Scope limitation—disclaimer (see paragraph 580.14)	First bullet: "We are unable to give an opinion on the fiscal year [year] financial statements of [name of entity] because of limitations on the scope of our work. Thus, the financial 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 financial statements."	"Disclaimer of Opinion on Financial Statements "As described above, we are unable to give an opinion on the financial statements."	Because we did not audit the financial statements, delete all references to the auditor's responsibility for auditing the financial statements and how that responsibility was fulfilled. (See note 2.)

Financial Statements				
Situation	Introduction	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope, and Methodology
3. Uncertainty—explanatory paragraph (see paragraph 580.19)	No changes.	No changes. (See note 7.)	Opinion on Financial Statements (see note 7): After the opinion, include an explanatory paragraph describing the uncertainty.	No changes.
4. Lack of consistency in the application of accounting principles—explanatory paragraph (see paragraph 580.20)	No changes.	No changes. (See note 7.)	Opinion on Financial Statements (see note 7): After the opinion, include an explanatory paragraph explaining the accounting change. For example: "As discussed in Note X to the financial statements, the entity changed its method of computing depreciation in fiscal year [year]."	No changes.

Financial Statements				
Situation	Introduction	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope, and Methodology
5. Departure from GAAP—qualified opinion (see paragraph 580.22)	First bullet: "Entity departed from generally accepted accounting principles in [identify account(s) affected by the departure from GAAP]. Otherwise the financial statements are presented fairly in conformity with generally accepted accounting principles."	Describe material departures from GAAP.	"Qualified Opinion on Principal Statements "Except for the departure from generally accepted accounting principles (United States of America) described above, the financial statements, including the accompanying notes, present fairly ..."	No changes.
6. Departure from GAAP—adverse opinion (see paragraph 580.22)	First bullet: "The financial statements are not presented fairly in conformity with generally accepted accounting principles."	Describe material departures from GAAP.	"Adverse Opinion on Financial Statements "Because of the departure from generally accepted accounting principles (United States of America) described above, the financial statements, including the accompanying notes, do not present fairly ..."	No changes.

Internal Control				
Situation	Bullets	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope, and Methodology
7. Scope limitation—disclaimer (see paragraph 580.39)	Second bullet: "We are unable to give an opinion on internal control 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 internal control."	"Disclaimer of Opinion on Internal Control "As described above, we are unable to give an opinion on internal control."	Because we did not perform adequate procedures to give an opinion on internal control, delete all references to the auditor's responsibility for giving such an opinion and how that responsibility was fulfilled. (See note 3.)

Internal Control				
Situation	Bullets	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope, and Methodology
8. Scope limitation on one objective—qualified opinion (see paragraph 580.39) (continued on next page)	Second bullet: "We are unable to give an opinion on internal control over [state objective affected, for example, financial reporting] because of limitations on the scope of our work. We found that management had effective internal control over [state objective not affected, for example, compliance with laws and regulations.]"	Describe significant limitations on the scope of the work. This should follow the discussion of a scope restriction on the audit of the financial 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 internal control over [state the affected control objective, such as financial reporting]."	"Qualified Opinion on Internal Control "As described above, we are unable to give an opinion on internal control over [state control objective affected]. However, we did evaluate internal control over [list control objective not affected by scope limitation]." State the opinion on the other objective: (continued on next page)	After the last sentence add: "We considered the limitations on the scope of our work in forming our conclusions."

Internal Control				
Situation	Bullets	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope, and Methodology
8. Scope limitation on one objective—qualified opinion (see paragraph 580.39) (continued from previous page)			"[Entity] maintained in all material respects effective internal control over [list unaffected areas, for example, financial reporting or compliance] as of [end of fiscal year] that provided reasonable assurance that [list unaffected areas, for example, misstatements and losses or noncompliance] material in relation to the financial statements or to stewardship information would be prevented or detected on a timely basis. Management asserted that its internal control over [financial reporting or compliance] was effective based on... [continue with second sentence].	

Internal Control				
Situation	Bullets	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope, and Methodology
9. Material weakness in internal control relevant to one or more control objective(s) (see paragraph 580.43) (continued on next page)	Second bullet: "[Entity] did not have effective internal control over [state objective(s) affected, for example, financial reporting], but had effective internal control over [state objective not affected, for example, compliance with laws and regulations]."	Describe material weaknesses in internal control 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 control may adversely affect any decision by management that is based, in whole or in part, on information that is inaccurate because of the deficiencies. (continued on next page)	"Adverse Opinion on Internal Control "Because of the material weakness(es) in internal control described above, [entity] did not maintain effective internal control over [state objective(s) affected, for example, financial reporting or compliance] as of [end of fiscal year], which thus did not provide reasonable assurance that [state control objective(s) affected, such as misstatements and losses or noncompliance] material in relation to the financial statements or to stewardship information would be prevented or detected on a timely basis." (continued on next page)	No changes unless both 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 Control				
Situation	Bullets	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope, and Methodology
9. Material weakness in internal controls relevant to one or more control objective(s) (see paragraph 580.43) (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."	If controls were effective over one objective, add the following: "However, [entity] maintained in all material respects effective internal control over [state objective not affected, such as compliance or financial reporting] as of [date of fiscal year-end] that provided reasonable assurance that [state appropriate effect(s) such as, noncompliance or mis-statements and losses] material in relation to the financial statements or to stewardship information would be prevented or detected on a timely basis." Continue with sentence about the basis of management's assertion. (continued on next page)	

Internal Control				
Situation	Bullets	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope, and Methodology
9. Material weakness in internal control relevant to one or more control objective(s) (see paragraph 580.43) (continued from previous page)			Opinion on Financial Statements: If the opinion on financial statements is unqualified, include the following at the end of the opinion on the financial 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 Control				
Situation	Bullets	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope, and Methodology
10. Reportable conditions (other than material weaknesses) (see paragraph 580.46) (continued on next page)	Second bullet: "Although internal controls should be improved, [entity] had effective internal control over ..."	For reportable conditions considered to be significant matters that should be communicated to the entity head, OMB, and the Congress (as defined in paragraph 580.52): Describe the weaknesses and indicate (1) that the weaknesses are not material weaknesses and (2) whether the weaknesses were reported by management in the summary of FMFIA reports. (continued on next page)	Opinion on Internal Control: No change to the two sentences. Following that, continue: "However, our work identified the need to improve certain internal control, 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 control, although not considered to be material weaknesses, represent significant deficiencies in the design or operations of internal control, which could adversely affect the entity's ability to meet the internal control objectives listed above or meet OMB criteria for reporting matters under FMFIA." (continued on next page)	No changes.

Internal Control				
Situation	Bullets	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope, and Methodology
10. Reportable conditions (other than material weaknesses) (see paragraph 580.46) (continued from previous page)		For reportable conditions that are not considered to be significant matters individually (as defined in paragraph 580.52): List the weaknesses. Combine related weaknesses.	Opinion on Financial Statements: If reportable conditions are included as significant matters and the opinion on the financial statements is unqualified, include the following at the end of the opinion on the financial 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 material weaknesses, see note 6.	

Internal Control				
Situation	Bullets	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope, and Methodology
11. The purpose was not to give an opinion on internal control and other reportable conditions were found (see paragraph 580.49) (continued on next page)	Second bullet: "No material weaknesses in internal control over financial reporting (including safeguarding assets) and compliance and its operation, although internal control 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 580.52) were found: Describe the weaknesses and indicate (1) that the weaknesses are not material weaknesses and (2) whether the weaknesses were reported by management in the summary of FMFIA reports. (continued on next page)	"Consideration of Internal Control "We considered internal control over financial reporting and compliance. "We do not express an opinion on internal control over financial reporting and compliance because the purpose of our work was to determine our procedures for auditing the financial statements and to comply with OMB audit guidance, not to express an opinion on internal control. However, our work identified the need to improve certain internal controls, as described above. These weaknesses in internal control, although not considered material weaknesses, represent significant deficiencies in the design or operation of internal control, which could adversely (continued on next page)	See note 8.

Internal Control				
Situation	Bullets	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope, and Methodology
11. The purpose was not to give an opinion on internal control and other reportable conditions were found (see paragraph 580.49) (continued from previous page)		If reportable conditions are not considered to be significant matters individually (as defined in paragraph 580.52): List the weaknesses. Combine related weaknesses.	affect the entity's ability to meet the internal control objectives listed in the objectives, scope, and methodology 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 components does not reduce to a relatively low level the risk that errors, fraud, or noncompliance 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 Control				
Situation	Bullets	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope, and Methodology
12. The purpose was not to give an opinion on internal control and one or a few material weaknesses were found (see paragraph 580.49) (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 control may adversely affect any decision by management that is based, in whole or in part, on information that is inaccurate because of the deficiencies. (continued on next page)	"Consideration of Internal Control "We considered internal control over financial reporting and compliance. "We do not express an opinion on internal control over financial reporting and compliance because the purpose of our work was to determine our procedures for auditing the financial statements and to comply with OMB audit guidance, not to express an opinion on internal control. 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 components does not reduce to a relatively low level the risk that errors, fraud, or noncompliance in amounts that would be material to (continued on next page)	See note 8.

Internal Control				
Situation	Bullets	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope, and Methodology
12. The purpose was not to give an opinion on internal control and one or a few material weaknesses were found (see paragraph 580.49) (continued from previous page)		Unaudited financial information reported by [name of entity], including budget information, also may contain misstatements resulting from these deficiencies."	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 Control				
Situation	Bullets	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope, and Methodology
13. The purpose was not to give an opinion on internal control and many material weaknesses were found (see paragraph 580.49) (continued on next page)	Second bullet: "Material weaknesses in internal control that resulted in ineffective controls over [state objectives(s) affected, for example, financial reporting]."	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 control may adversely affect any decision by management that is based, in whole or in part, on information that is inaccurate because of the deficiencies. (continued on next page)	"Consideration of Internal Control "We considered internal control over financial reporting and compliance. "We do not express an opinion on internal control over financial reporting and compliance because the purpose of our work was to determine our procedures for auditing the financial statements and to comply with OMB audit guidance, not to express an opinion on internal control. However, we found the material weakness(es) described above, which resulted in ineffective controls over [state objective(s) affected, for example, financial reporting]. A material weakness is a condition in which the design or operation of one or more of the internal control components (continued on next page)	See note 8.

Internal Control				
Situation	Bullets	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope, and Methodology
13. The purpose was not to give an opinion on internal control and many material weaknesses were found (see paragraph 580.49) (continued from previous page)		Unaudited financial information reported by [name of entity], including budget information, also may contain misstatements resulting from these deficiencies."	does not reduce to a relatively low level the risk that errors, fraud, or noncompliance 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
14. Scope limitation —some laws could not be tested (see paragraph 580.68)	Third bullet: "No reportable noncompliance with laws and regulations we tested and no instances ... (FFMIA); 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 and FFMIA Requirements "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 (United States of America) or OMB audit guidance; however, as discussed above, we could not test all the laws we considered necessary." [Continue paragraph with second sentence about FFMIA and last two sentences.]	Exclude laws not tested from list of laws. After the last sentence add: "We considered the limitations on the scope of our work in forming our conclusions."

Compliance with Laws and Regulations				
Situation	Bullets	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope and Methodology
15. Scope limitation —all laws could not be tested— disclaimer (see paragraph 580.68)	Third bullet: "We were unable to test [entity's] compliance with laws and regulations because of limitations on the scope of our work. However, we found no instances in which [entity's] financial management systems did not substantially comply with the requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA)." If FFMIA was also affected by scope limitations, delete references to it.	Describe scope limitation. Conclude with: "Because of this limitation on the scope of our work, we were unable to test [entity's] compliance with laws and regulations."	Compliance With Laws and Regulations and FFMIA Requirements: 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 other than FFMIA." Continue with the second sentence about FFMIA (preceded with "however,") but omit the last two sentences. If FFMIA was also affected by scope limitations, delete references to it.	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
16. Material noncompliance with laws and regulations (see paragraph 580.63)	Third bullet: "Reportable noncompliance with laws and regulations we tested but no instances ... (FFMIA)."	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 and FFMIA Requirements: "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 (United States of America) or OMB audit guidance." [Continue paragraph with second sentence about FFMIA and last two sentences.]	No changes.

Compliance with Laws and Regulations				
Situation	Bullets	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope and Methodology
17. Reportable noncompliance (other than material noncompliance) (see paragraph 580.63)	Third bullet: "Reportable noncompliance with laws and regulations we tested but no instances ... (FFMIA)."	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 financial statements. For reportable noncompliance that is not considered to be significant: List the noncompliance. Combine related instances of noncompliance.	Compliance With Laws and Regulations and FFMIA Requirements: "Except as noted above, our tests for compliance with selected provisions of laws and regulations disclosed no other instances of noncompliance that would be reportable under generally accepted government auditing standards (United States of America) or OMB audit guidance." [Continue paragraph with second sentence about FFMIA and last two sentences.]	No changes.

Compliance with Laws and Regulations				
Situation	Bullets	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope and Methodology
18. Lack of financial management systems' substantial compliance with FFMIA requirements (see paragraph 580.72) (continued on next page)	Third bullet: "No reportable noncompliance with laws and regulations we tested other than FFMIA but instances in which [entity's] financial management systems did not substantially comply with the requirements of the FFMIA.	Describe instances of lack of substantial compliance of financial management systems with federal financial management systems requirements, federal accounting standards, or the SGL at the transaction level. Indicate whether each instance was reported by management in FMFIA reports. In addition, as required by FFMIA, identify the entity or organization responsible for the systems found not to comply; include the nature and extent of the noncompliance, primary reason or cause, and relevant management comments; and make recommendations (in the recommendation section) and set time frames for implementing recommendations.	Compliance With Laws and Regulations and FFMIA Requirements: "Our tests for compliance with selected provisions of laws and regulations, other than FFMIA, disclosed no instances of noncompliance that would be reportable under generally accepted government auditing standards (United States of America) or OMB audit guidance. However, our tests disclosed instances, described above, in which [entity's] financial management systems did not substantially comply with [specify the requirements where a lack of substantial compliance was found, such as federal financial management systems requirements and the *U.S. Government Standard General Ledger* at the transaction level]. (Continued on next page.)	No changes.

Compliance with Laws and Regulations				
Situation	Bullets	Significant Matters (see note 1)	Opinion or Conclusion	Objectives, Scope and Methodology
18. Lack of financial management systems' substantial compliance with FFMIA requirements (see paragraph 580.72) (continued from previous page)			Our tests disclosed no instances in which [entity's] financial management systems did not substantially comply with [specify the requirements where no lack of substantial compliance was found, such as federal accounting standards]."	

Consistency of Other Information (MD&A (Overview), Required Supplementary Information (including Stewardship Information), and Other Accompanying Information)				
Situation	Introduction	Significant Matters (see note 1)	Opinion or Conclusions	Objectives, Scope, and Methodology
19. Material inconsistency between other information and financial statements (see paragraph 580.76)	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 Accountability Report (or annual financial statement)—MD&A (or overview), required supplementary information (including stewardship information), other accompanying information—that is not consistent with the financial statements] is inconsistent with the financial statements." If certain type(s) of information are consistent, add: "Otherwise, we found no other material inconsistencies with the financial statements and the [state type(s) of information not affected] or nonconformance with OMB guidance."	No changes.

Consistency of Other Information (MD&A (Overview), Required Supplementary Information (including Stewardship Information), and Other Accompanying Information)				
Situation	Introduction	Significant Matters (see note 1)	Opinion or Conclusions	Objectives, Scope, and Methodology
20. Nonconformance of other information with OMB guidance (see paragraph 580.76)	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 Accountability Report (or annual financial statement)—MD&A (or overview), required supplementary information, or other accompanying 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 financial statements or nonconformance of the [state type(s) of information not affected] with OMB guidance."	No changes.

Consistency of Other Information (MD&A (Overview), Required Supplementary Information (including Stewardship Information), and Other Accompanying Information)				
Situation	Introduction	Significant Matters (see note 1)	Opinion or Conclusions	Objectives, Scope, and Methodology
21. Any situation that caused the auditor to modify the report on the financial statements, internal control, or compliance with laws and regulations that also affects other information (see paragraph 580.80)	No changes.	In the discussion of the situation, include the effects on the other information in the Accountability Report.	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 Accountability Report—MD&A (overview), required supplementary information, or other accompanying information) if considered to be misleading in light of the particular situation. Omit statement that we found no inconsistencies or nonconformance if there is a scope limitation that resulted in a disclaimer of a report on the financial statements.	If a scope limitation on the work on the principal statements, internal control, 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 describe...":

"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 financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles], and (2)" [continue with rest of paragraph].

Delete the following:

" (1) examined, on a test basis, evidence supporting the amounts and disclosures in the financial statements,

(2) assessed the accounting principles used and significant estimates made by management,

(3) evaluated the overall presentation of the financial statements,"

Add the following words in quotation marks:

We performed our work in accordance with generally accepted government auditing standards (United States of America) and OMB audit guidance. "We considered the limitations on the scope of our work in forming our conclusions."

Note 3: Disclaimer of opinion on internal control 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 financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles "and (2) management maintained effective internal control, the objectives of which are the following:

- Financial reporting: Transactions are properly recorded, processed, and summarized to permit the preparation of financial statements and stewardship information in conformity with generally accepted accounting principles, and assets are safeguarded against loss from unauthorized acquisition, use, or disposition.

- Compliance with laws and regulations: Transactions are executed in accordance with laws governing the use of budget authority and with other laws and regulations that could have a direct and material effect on the financial statements and any other laws, regulations, and governmentwide policies identified by OMB audit guidance." [continue with rest of paragraph]

Delete the following:

" (4) obtained an understanding of internal control related to financial reporting (including safeguarding assets), compliance with laws and regulations (including execution of transactions in accordance with budget authority), and performance measures reported in Management's Discussion and Analysis (or the overview) of the Accountability Report;

(5) tested relevant internal controls over financial reporting (including safeguarding assets), compliance, and evaluated the design and operating effectiveness of internal control;

(6) considered the process for evaluating and reporting on internal control and financial management systems under the Federal Managers' Financial Integrity Act of 1982," ...[continue with rest of paragraph]

"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 over financial reporting and compliance. Because of inherent limitations in internal control, misstatements due to error or fraud, losses, or noncompliance 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:

We performed our work in accordance with generally accepted government auditing standards (United States of America) and OMB audit guidance. "We considered the limitations on the scope of our work in forming our conclusions."

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 (1) selected provisions of laws and regulations that have a direct and material effect on the financial statements, (2) laws for which OMB audit guidance requires testing, and (3) FFMIA requirements.... [continue with rest of paragraph].

Delete the following:

" (7) tested compliance with selected provisions of the following laws and regulations [do not list any laws and regulations]; and (8) tested whether [entity's] financial management systems substantially comply with FFMIA requirements, using OMB implementation guidance."

Add the following words in quotation marks:

We performed our work in accordance with generally accepted government auditing standards (United States of America) and OMB audit guidance. "We considered the limitations on the scope of our work in forming our conclusions."

Note 5: Disclaimer of a report on the financial statements, internal control, or compliance with laws and regulations

If scope limitations on our work on the financial statements, internal control, 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 performing limited procedures with respect to certain other information appearing in the Accountability Report."

Add the following words in quotation marks:

We performed our work in accordance with generally accepted government auditing standards (United States of America) and OMB audit guidance. "We considered the limitations on the scope of our work in forming our conclusions."

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 internal control should include the changes for material weaknesses first, and then should continue with an additional paragraph for reportable conditions that begins either "Our work also identified the need to improve certain internal controls..." or "Management also 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 580.26.

Note 8: No management assertion about the effectiveness of internal control

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 financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles "and (2) management maintained effective internal control, the objectives of which are the following:

- Financial reporting: Transactions are properly recorded, processed, and summarized to permit the preparation of financial statements and stewardship information in conformity with generally accepted accounting principles, and assets are safeguarded against loss from unauthorized acquisition, use, or disposition.

- Compliance with laws and regulations: Transactions are executed in accordance with laws governing the use of budget authority and with other laws and regulations that could have a direct and material effect on the financial statements and any other laws, regulations, and governmentwide policies identified by OMB audit guidance." ... [continue with rest of paragraph]

Insert the following words in quotation marks into the sentence following the objectives:

We are also responsible for "obtaining a sufficient understanding of internal control over financial reporting and compliance to plan the audit and for" testing compliance with ...

Add the following sentence at the end of the paragraph that begins, "We did not evaluate all internal controls..."

"In addition, we caution that our internal control testing may not be sufficient for other purposes."

[This page intentionally left blank.]

595 C - EXAMPLE SUMMARY OF POSSIBLE ADJUSTMENTS

Summary of Possible Adjustments
(In Thousands)

From W/P	Description	Known misstatements		Likely misstatements		Corrected by entity? [a]	W/P Ref [b]
		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*		

Note: Conclude (in consultation with the Reviewer as discussed in 540.04) as to the adequacy of the scope of procedures performed in light of the total likely misstatements above. (This is the document that is attached to the management representation letter, per SAS 89.)

[a] Post any uncorrected known or likely misstatements to the Summary of Unadjusted Misstatements for further consideration.

[b] 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.

[This page intentionally left blank.]

595 D - EXAMPLE 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).

(Dollars 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 percentage 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)		$(1,400)	(1,400)	reference	120,000	1.17%
Interest receivable	3	120		120	220		220	the adjusted	60,000	(0.37)%
Total assets		**$ 220**	**$(1,400)**	**$(1,180)**	**$ 320**	**$(1,400)**	**$(1,080)**	account balances to	**$ 272,000**	**0.40%**
Liabilities:								the		
Accounts payable	4		$ (150)	$ (150)		$ (350)	$ (350)	appropriate working	$(175,000)	(0.20)%
Other liabilities	5		(40)	(90)		(100)	(300)	paper (for	(85,000)	(0.35)%
	6		(50)			(200)		example, the		
Total liabilities		$ 0	(240)	(240)	$ 0	(650)	(650)	final trial balance)].	(260,000)	(0.25)%
Equity of U.S. government:										
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%**

(Dollars 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 percentage 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)	$ 0	(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		125,000	(0.16)%
Provision for losses	2	1,400		1,400	1,400		1,400		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 financial statements taken as a whole from a quantitative or qualitative viewpoint. Unadjusted misstatements relating to the materiality base (operating expenses) are only 0.28 percent of the base ($2.05 million divided by $740 million).

[This page intentionally left blank.]

APPENDIXES

[This page intentionally left blank.]

Appendix A

CONSULTATIONS

REVIEWER

.01 The paragraphs listed below refer to situations in which the auditor should consult with the Reviewer:

100.27	Departing from a policy or procedure designated as "must" or "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 increased overall audit assurance.
285.04, 295 C	Using a plan other than that described in section 295 C for selecting locations to visit.
395 G.07	Planned rotation of IS control testing.
480.13	Using nonstatistical sampling.
480.41	Determining the adequacy of substantive procedures in light of any reassessment of combined risk.
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.
540.09	Reviewing documentation of a decision to modify the opinion based on the materiality of total unadjusted likely 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.

540.17 Considering the performance of additional procedures to increase assurance in projected misstatements.

540.19 Considering whether misstatements may be the result of fraud.

580.40 Determining the appropriate type of opinion on internal control when there is a scope limitation.

580.48 Considering the opinion on internal control.

580.70 Determining the effects on the auditor's report if weaknesses are found in compliance controls but no instances of noncompliance are detected.

595 C Reviewing the Summary of Possible Adjustments.

STATISTICIAN

.02 The following paragraphs refer to situations in which the auditor should consult with the Statistician:

295 C.04 Using classical variables sampling or another representative sampling method to select locations.

410.03 Consulting for assistance in designing and evaluating samples.

440.02 Expanding the sample size to test additional items.

450.07 Determining sample sizes for tests of controls when not using Tables I and/or II.

450.09 (footnote) Computing reduced sample sizes and evaluating results for small populations.

450.16 Continuing to test a sample when deviations exceed the acceptable number.

450.17 Expanding the sample to test additional items.

450.18	Projecting the rate of sample control deviations to a population for a report.
460.02	Expanding the sample to test additional items.
460.02 (footnote)	Computing reduced sample sizes and evaluating results for small populations.
480.13	Using nonstatistical sampling.
480.17	Using a method of sampling other than attributes, dollar-unit, classical variables estimation, or classical probability-proportionate-to-size sampling.
480.21 (footnote)	Deciding when to use DUS versus classical variables estimation sampling.
480.28, 480.30	Expanding a dollar-unit sample.
480.33	Using classical variables estimation sampling.
480.38	Sampling when dollar amounts are not known.
480.39	Evaluating sample results for substantive tests.
480.42	Evaluating samples designed to test existence when understatements are found.
480.44	Evaluating dollar-unit samples when a significant number of misstatements is found.
480.45	Evaluating classical variables estimation sampling.
480.46	Evaluating the results of other samples.
540.11	Computing the combined precision for all sampling applications.

OGC

.03 The paragraphs listed below refer to situations in which the auditor should consult with OGC:

245.02a.	Identifying laws and regulations that have a direct effect on determining amounts in the financial statements.
250.01, 250.03, 250.05	Identifying relevant budget restrictions.
370.12	Determining the legal implications of indications that internal control might not provide reasonable assurance that the entity executed transactions in accordance with budget authority.
395 F.01 (footnote)	Identifying any impoundments (rescissions or deferrals) as a result of evaluating budgetary controls.
395F Sup.01c.	Determining, prior to performing control or compliance tests, the applicability of budget restrictions to modifications made to direct loans, direct loan obligations, loan guarantees, or loan guarantee commitments that were outstanding prior to October 1, 1991.
460.07	Evaluating possible instances of noncompliance noted in connection with compliance testing.
540.19, 540.21	Considering whether misstatements may be the result of fraud.
580.62	Concluding on the entity's compliance with laws and regulations.
580.70	Determining the effects on the auditor's report if weaknesses are found in compliance controls but no instances of noncompliance are detected.

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:

100.04 (footnote)	In opining on internal control, the opinion must be on internal control and not management's assertion if material weaknesses are present.
100.17	The audit must be designed to achieve the objectives of OMB audit guidance.
295 C.07	The auditor must apply analytical or other substantive procedures to locations not tested in using nonrepresentative sample selection, unless immaterial.
310.06	The auditor must evaluate and test certain controls.
310.08	The auditor must test the effectiveness of controls if the controls have been determined to be effective in design.
340.09	The auditor must test controls that are likely to be effective.
395 G.02	In using rotation testing of controls, the auditor must annually perform some work in areas not selected for testing.
475.07	In order to rely on a substantive analytical procedure, a difference that exceeds the limit must be explained.
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 When using nonrepresentative selection, the auditor must not project results to the portion of the population not tested and must apply other procedures to the remaining items unless immaterial.

480.07 In representative sampling, each item in the population must have the opportunity to be selected.

480.14 In sampling, sample items must be selected from all items so that each item has an opportunity to be selected.

480.47 The auditor must evaluate the quantitative and qualitative effects of known and projected misstatements in relation to the 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 by means other than 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 IS 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, FFMIA requirements, 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, final current-year amounts.

540.07 The auditor must bring all misstatements found to management's attention (except those below the auditor-designated amount at which misstatements need not be accumulated).

570.01 The auditor must determine whether the audit was conducted in accordance with GAGAS, OMB audit guidance, and the GAO/PCIE financial audit methodology, and document the conclusion on compliance in the workpapers.

580.14 The auditor must determine whether the audit was conducted in accordance with GAGAS and OMB audit guidance.

580.22 The auditor must consider whether the financial statements are materially affected by a departure from generally accepted accounting principles.

580.39 In order to express an opinion on internal control, the auditor must have a management assertion about the effectiveness of internal control and must be able to perform all the procedures considered necessary. (Two "musts" in paragraph.)

[This page intentionally left blank.]

GLOSSARY

[This page intentionally left blank.]

GLOSSARY

Accountability report An agency's accountability report integrates the (1) Federal Managers' Financial Integrity Act (FMFIA) Report; (2) Chief Financial Officers' (CFO) Act Annual Report, including audited financial statements; (3) Management's Report on Final Action as required by the Inspector General Act; (4) the Debt Collection Improvement Act, Civil Monetary Penalty Act and Prompt Payment Act reports; and (5) available information on agency performance compared with the agency's stated goal and objectives.

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 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 (referred to as the Accountability Report throughout the FAM)

As defined by OMB, the annual financial statement comprises

- an overview of the reporting entity (or Management's Discussion and Analysis, MD&A),
- the financial statements and related notes,
- required supplementary stewardship information,
- required supplementary information, and
- other accompanying information.

Application controls

Management's control activities that are incorporated directly into individual computer applications to provide reasonable assurance of accurate and reliable procession. Application controls address (1) data input, (2) data processing, and (3) data output. FISCAM categories of application controls that more closely tie into the FAM methodology are (1) authorization control, (2) completeness control, (3) accuracy control, and (4) control over integrity of processing and data files.

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 control in preventing or detecting misstatements in financial statement assertions.

Audit risk

The risk that the auditor may unknowingly fail to appropriately modify his or 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 (see title 7 of the GAO *Policies and Procedures Manual for Guidance of Federal Agencies*). 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
- contract authority

Budget controls Management's policies and procedures to manage and control the use of appropriated funds and other forms of budget authority. (These are considered part of financial reporting and compliance controls.)

Closed account A budget account for which the expired budget authority has been canceled.

Combined risk Combined inherent and control risk (high, moderate, or low); the risk that the financial statements contain material misstatements before audit.

Compliance controls A process, effected by management and other personnel, designed to provide reasonable assurance that transactions are executed in accordance with (1) laws governing the use of budget authority and other laws and regulations that could have a direct and material effect on the financial statements or required supplementary stewardship information and (2) any other laws, regulations, and governmentwide policies identified in OMB audit guidance.

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 A component of internal control, in addition to risk assessment, monitoring, information and communication, and control activities. The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. The control environment represents the collective effect of various factors on establishing, enhancing, or mitigating the effectiveness of specific control activities. Such factors include (1) integrity and ethical values, (2) commitment to competence, (3) management's philosophy and operating style, (4) organizational structure, (5) assignment of authority and responsibility, (6) human resource policies and practices, (7) control methods over budget formulation and execution, (8) control methods over compliance with laws and regulations, and (9) oversight groups.

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 activities (techniques) A component of internal control, in addition to the control environment, risk assessment, monitoring, and information and communication. The policies and procedures that help ensure that management directives are carried out.

Control tests	Tests of a specific control activity 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 should 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. (See discussion in paragraph 230.12.)
Detection risk	The risk that audit procedures will not detect a material misstatement that exists in the financial statements.
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.
Expected misstatement	The dollar amount of misstatements the auditor expects in a population.
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 canceled and are then considered to be closed accounts.
Federal financial management systems requirements	One of the three requirements of FFMIA. They include the requirements of OMB Circulars A-127, A-123, and A-130 and the JFMIP Federal Financial Management Systems Requirements series.

Financial reporting controls

A process, effected by management and other personnel, designed to provide reasonable assurance that transactions are properly recorded, processed, and summarized to permit the preparation of the financial statements and required supplementary stewardship information in accordance with GAAP, and that assets are safeguarded against loss from unauthorized acquisition, use, or disposition.

Financial statements (also called principal statements)

The components of a federal entity's annual financial statement (also referred to as the Accountability report), which are

- Balance Sheet
- Statement of Net Cost
- Statement of Changes in Net Position
- Statement of Budgetary Resources
- Statement of Financing
- Statement of Custodial Activity (if applicable)
- Related Notes

Fraud

Intentional misstatements or omissions of amounts or disclosures in financial statements. The auditor is interested in fraudulent acts that cause a material misstatement of financial statements. Fraud is distinguished from error because fraud is intentional whereas error is unintentional. Two relevant types of misstatements are those arising from fraudulent financial reporting and those arising from misappropriation of assets.

Fraudulent financial reporting Intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users. This may involve acts such as manipulation, falsification, or alteration of accounting records or supporting documents; misrepresentation or intentional omission of events, transactions, or other significant information in the financial statements; or intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure.

General controls Management's policies and procedures that apply to an entity's overall computer operations and that create the environment in which application controls and certain user controls (which are control activities) operate. They are classified in the FISCAM as (1) entitywide security management program, (2) access control, (3) application software development and change control, (4) system software, (5) segregation of duties, and (6) service continuity control.

Generally accepted accounting principles (GAAP) The accounting principles that the entity should use. For federal executive agencies, these are federal accounting standards following the hierarchy listed in SAS 91. The standards issued by FASAB are the first level of the hierarchy. For government corporations, generally accepted accounting principles are commercial generally accepted accounting principles issued by FASB.

Information and communication A component of internal control in addition to the control environment, risk assessment, monitoring, and control activities. The identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities. The accounting system and accounting manuals are examples of this component.

Information systems (IS) auditor A person with specialized technical knowledge and skills who can understand the IS concepts discussed in the manual and apply them to the audit.

IS controls Controls whose effectiveness depends on computer processing, including general, application, and user controls (described in section 295 F).

Inherent risk The susceptibility of an assertion to a material misstatement, assuming there are no related specific control activities.

Internal control A process, effected by an entity's management and other personnel, to provide reasonable assurance that the entity's specific objectives are achieved. Following are the types of internal controls:

- financial reporting (including safeguarding and budget)
- compliance (including budget)
- operations

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.

Misappropriation of assets Theft of an entity's assets causing the financial statements not to be presented in conformity with GAAP.

Monitoring A component of internal control in addition to the control environment, risk assessment, information and communication, and control activities. The process by which management assesses internal control performance over time. It may include ongoing activities, separate evaluations, or a combination of both.

Multipurpose testing Performing several tests, such as control tests, compliance tests, and substantive tests, on a common selection.

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 organizational objectives, such as 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 MD&A of the Accountability report are properly recorded, processed, and summarized to permit preparation of performance information in accordance with criteria stated by management.
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 statements	See financial statements.
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.
Recorded amount	The financial statement amount being tested by the auditor in the specific application of substantive tests.

Risk assessment A component of internal control in addition to the control environment, monitoring, information and communication, and control activities. The entity's identification and analysis of relevant risks to achievement of its objectives, forming a basis for determining how the risks should be managed.

Safeguarding controls Internal controls to protect assets from loss from unauthorized acquisition, use, or disposition arising from misstatements in processing transactions and handling the related assets. Safeguarding controls are considered part of financial reporting controls. Some safeguarding controls are operations controls.

Sampling The application of audit procedures to fewer than all items composing 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.

Sampling interval The amount between two consecutive sample items, used in selecting the items in systematic sampling. In dollar-unit sampling, this amount may be 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 activities. This process is documented on the SCE worksheet.

Standard General Ledger (SGL) at the transaction level

One of the three requirements of FFMIA. Implementing the SGL at the transaction level means that the entity's general ledger is in full compliance with the SGL chart of accounts descriptions and posting rules, that transactions from feeder systems are summarized and fed into the general ledger following SGL requirements through an automated or manual interface, that detail supporting these transactions can be traced back to the source transactions in the feeder systems, and that the feeder systems process transactions consistent with SGL account descriptions and posting.

Stewardship information

Required supplementary stewardship information includes (1) stewardship property, plant, and equipment (property owned by the federal government including: heritage assets [PP&E of historical, natural, cultural, educational, or artistic significance], national defense PP&E [weapons systems and vessels], and stewardship land [land other than that acquired for, or in connection with, general PP&E]), (2) stewardship investments (items treated as expenses in calculating net cost but meriting special treatment to highlight their substantial investment and long-term-benefit nature, including: nonfederal physical property [grants provided for properties financed by the federal government but owned by the state and local governments], human capital [education and training programs financed by the federal government for the benefit of the public], and research and development [basic and applied]), (3) stewardship responsibilities (current services assessment showing receipt and outlay data on the basis of projections of future activities—required in the consolidated statements of the U.S. government only—and social insurance information), and (4) risk-assumed information on insurance and guarantee programs (generally, the present value

of unpaid expected losses net of associated premiums).

Stratification Separation of a population into relatively homogeneous groups, each of which is referred to as a stratum, usually to improve sampling efficiency in a classical variables sample.

Substantial compliance Financial management systems comply substantially with the three requirements of FFMIA (federal financial management systems requirements, federal accounting standards, and the SGL at the transaction level) when they comply with the indicators referenced in OMB audit guidance.

Substantive analytical procedures Analytical procedures used as substantive tests.

Substantive tests Specific tests to detect material misstatements in an assertion relating to 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 (tolerable misstatement) The materiality used in determining the extent of a specific substantive test. Test materiality is design materiality, 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 users of the financial statements; or
- the auditor expects to find a significant amount of misstatements.

Tolerable misstatement	See test materiality.
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. Top stratum items are tested 100 percent.
User controls	Manual comparisons of computer output (generally totals) to source documents or other input (including control totals).
Walkthroughs	Audit procedures to help the auditor understand 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; observing the processing and applicable controls in operation; making inquiries of personnel applying the controls; and examining related documents.

FISCAM has a glossary of IS terms.

[This page intentionally left blank.]

ABBREVIATIONS

[This page intentionally left blank.]

ABBREVIATIONS

AcSEC	Accounting Standards Executive Committee of the AICPA
AICPA	American Institute of Certified Public Accountants
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 Officer
COSO	Committee of Sponsoring Organizations of the Treadway Commission
DUS	dollar-unit sampling
FASAB	Federal Accounting Standards Advisory Board
FASB	Financial Accounting Standards Board
FBWT	fund balance with Treasury
FISCAM	Federal Information System Controls Audit Manual
FFMIA	Federal Financial Management Improvement Act of 1996
FMFIA	Federal Managers' Financial Integrity Act of 1982
GAAP	generally accepted accounting principles
GAAS	generally accepted auditing standards
GAGAS	generally accepted government auditing standards
GAO	General Accounting Office

GRA	General Risk Analysis
IG	Inspector General
IS	Information Systems
JFMIP	Joint Financial Management Improvement Program
MD&A	management's discussion and analysis
OGC	Office of General Counsel
OMB	Office of Management and Budget
OPM	Office of Personnel Management
PCIE	President's Council on Integrity and Efficiency
PP&E	property, plant, and equipment
RSSI	required supplementary stewardship information
SAS	Statement on Auditing Standards
SCE	Specific Control Evaluation
SFFAS	Statement of Federal Financial Accounting Standards
SGL	U.S. Government Standard General Ledger
SSAE	Statement on Standards for Attestation Engagements
W/P	workpaper

INDEX

[This page intentionally left blank.]

INDEX

Account Risk Analysis (ARA)
- Control risk and combined risk, Preliminary assessment of 370.10
- Documentation of internal control phase 390.07
- Documentation of planning phase 235.06, 290.06
- Sample completed form . . . . . 395 I

Accounting application
- Audit requirements for internal controls 310.06
- Description 240.02
- Documentation 390.04
- Potential misstatements 330.06
- Relation to line items/accounts . . . . . 330.05, 395 A
- Walkthrough procedures 320.02

Accounting principles and policies
- Determining compliance with 560.01

Accounting systems
- Understanding 320.01

Analytical procedures
- Overall 520.01
- Preliminary 225.01
- Substantive 470.04, 475.01
- Supplemental 470.05, 475.17, 520.03

Application controls
- See IS controls

Assertions
- Audit requirements for internal controls 310.06
- Combined risk, Preliminary assessment of 370.09
- Control risk, Preliminary assessment of 370.07
- Control activities, Effectiveness of 340.02
- Definition 235.02
- Management, about internal control
  - See Internal control
- Relation to potential misstatements and control objectives 330.02
- Significant 235.04

Audit assurance
Guidelines 260.04

Audit matrix 470.10
With statistical risk factors . . . . . 495 D

Audit reports
See Report on Accountability Report (annual financial statement)
See Reports on financial statements

Audit risk
Definition 260.02
Guidelines 260.04

Audit sampling
See Sampling

Audit scope 530.01, 580.14, 580.37, 580.68, 580.80

Audit summary memorandum 590.02

Auditing standards and related OMB guidance
Audit requirements beyond "yellow book" (GAGAS) 100.16
Determine compliance with 570.01
Relevant standards 100.13
Standards and other policies not addressed 100.18

Budget
Audit requirements 310.05
Controls . . . . . 260.06, 295 G, 310.04
Budget accounting system 320.05
Control objectives . . . . . 330.09, 395 F
Execution statutes . . . . . 395 D
Execution steps . . . . . 395 E
Formulation, understanding 260.32
Definition 260.06
Documentation 390.05
Preliminary assessment of effectiveness 370.11
Reporting 370.11, 580.32
Restrictions, identifying 250.01

Combined risk
Assurance level for substantive tests, Relationship to 370.10, 470.02
Definition 370.09
Effect on audit procedures . . . . . 295 E
Reevaluation of assessment 370.14

Compliance with laws and regulations
Checklist, General compliance 802
Identifying significant laws and regulations 245.01
Laws identified in OMB audit guidance . . . . . 295 H
Material noncompliance, definition 580.63
Reportable noncompliance, definition 580.63
Reporting on 580.62
Reporting on management's FMFIA reports 580.62
Scope of procedures 580.68
Supplements, Compliance . . . . . 803 - 816
See Compliance controls
See Compliance tests

Compliance controls
Audit programs . . . . . 803 - 816
Audit requirements 310.07
Compliance system 320.06
Control objectives 330.10
Definition 260.06
Documentation 390.05
Effect on compliance tests 370.11, 460.02, 460.03, 460.06
Preliminary assessment of effectiveness 370.11
Reporting requirements 370.11, 580.31

Compliance tests
Definition 410.01
Evaluation of results 460.07
Procedural-based provisions 460.06
Quantitative-based provisions 460.03
Tests of budget information for use in . . . . . 495 B
Transaction-based provisions 460.02

Control environment 260.43
Documentation 290.04
Factors for consideration 260.32
IS effects on 260.41
Potential weaknesses . . . . . 295 B
Weaknesses 260.09

Control objectives
Identifying 330.01
Potential misstatements, Relationship to 330.02
See Budget controls
See Compliance controls
See Financial reporting controls
See Operations controls
See Safeguarding controls

Control risk
Assessment of 370.06, 370.14
Combined risk, Component of 370.09
Definition 260.02
Documentation of assessment 370.10

Control activities
Definition 260.08
Documentation 340.01, 390.06
Effectiveness of 340.02
Efficiency of testing 350.05
Factors for evaluating design effectiveness 340.03
Identification 340.01
IS controls, Identification of 350.09
Segregation of duties 330.08
Specific control evaluation 340.01, 390.06
Typical, List of . . . . . 395 C
Understanding 340.02

Control tests
Attribute sampling 450.01
Control Assessment, Relation to 370.01
Documentation . . . . . 390.06, 395 H, 450.02, 490.06
Efficiency considerations 350.17
Evaluation of results, nonsampling tests 360.14
Evaluation of results, sampling tests 450.13
Evidence, Documentary 350.15
Inquiry 350.12
IS controls, Performing tests of 360.03
IS controls, Evaluating results of 370.03
Inspection 350.13
Multiple locations, Impact on sampling control tests of 450.04
Nature 350.10
Nonsampling tests 350.18
Observation 350.11
Partial-year controls 380.02
Planned changes in controls 380.03
Population, sampling control tests 450.04
Rotation testing of controls . . . . . 380.01, 395 G
Sample size 450.06
Samples, Design of 450.02
Sampling control tests 410.01, 450.01
Segregation of duties 330.08, 360.12, 395 C.03
Selection of 350.17
Timing 350.17
Tolerable rate of deviations, sampling control tests 450.08

Cycle
Audit requirements for internal controls 310.06
Documentation 390.04
Identification 240.01

Cycle matrix 240.06, 290.05

Detail tests 470.07, 480.01

Detection risk 260.02

Differences in estimates 540.05

Discussion and analysis
See Management's discussion and analysis

Dual-purpose tests
See Multipurpose testing

Entity profile 290.03

Errors
See Misstatements

FFMIA
Conclude 460.07
Determine nature, timing, extent of tests 350.02-.04, 350.20-.22
Documentation 590.02-.03, 590.07
Indicators of substantial compliance . . . . . 395 J
Planning 260.48-.50
Reporting 580.72-.75
Requirements 100.09, 320.04
Testing 360.02, 360.16
Understanding accounting systems 320.04

Financial reporting controls
Accounting system 320.03
Audit requirements 310.06
Control objectives 330.01
Definition 260.06
Documentation 390.04
Preliminary assessment of control risk 370.06
Reporting requirements 580.32
Sampling control tests 450

Flowcharts, Use of 390.04

FMFIA
Assessing 260.43, 580.61
Material weakness 580.35
Reliance on management's process 260.47, 320.01
Reporting on management's reports 580.61

Fraud risk
Auditor responses . . . . . 295 I
Consideration 260.01
Continuing assessement 440.03
Documentation 290.04, 590.03
Factors 260.18
Reassessment 540.18

GAO/PCIE Financial Audit Manual, Compliance with 570.01

General Controls
See IS controls

General Risk Analysis (GRA) 290.04

Information and communication 320.01

Information Systems (IS) controls
See IS controls

Inherent risk
Definition 260.02
Documentation 290.04
Identifying 260.09
IS effects on 260.17
Risk factors . . . . . 260.16, 295 A

Inquiries of attorneys 280.02, 550.02

Interim testing . . . . . 295 D, 495 C

Internal control
Audit requirements 310.06
Classifying control weaknesses 580.33
Components 260.08
Effects of control weaknesses on internal control opinion 580.42
Management assertion about 550.08, 580.38-.48
Material weakness 580.36
Nonopinion report 580.49
Opinion report 580.38

Internal control (continued)
Reportable condition 580.33
Reporting on 580.32
Reporting on management's FMFIA reports 580.35, 580.61
Reporting weaknesses 580.51
Scope of procedures 580.39
See Budget controls
See Compliance controls
See Control activities
See Control environment
See Financial reporting controls
See Information and communication
See Monitoring
See Operations controls
See Risk assessment

IS controls
Application controls 295 F.05
Assessing . . . . . 295 J
Control activities, Identification for testing 350.09
Determining likelihood of effective 270.01
Develop high-level understanding 220.07
Documentation 290.04, 370.05
Effects on inherent risk 260.17
Effects on the control environment, risk assessment,
communication, and monitoring 260.41
General controls 295 F.02
Information system (IS) 320.01
IS auditor, Use of 100.26, 220.07, 260.17, 260.42
270.01, 320.01, 340.01, 350.09, 360.03
Testing 360.03
Types of . . . . . 295 F
User controls 295 F.07

Laws and regulations
See Compliance with laws and regulations

Management's discussion and analysis (MD&A) 100.12, 220.07
520.06, 580.76-.78, 590.06
Coordination with overall analytical procedures 520.06
Reporting on 580.78

Management letter 580.54, 580.64

Management representations 280.03, 550.07, 1001

Materiality
Base, Definition and use of 230.08
Definition of 230.01
Design 230.05, 230.12
Disclosure 230.06
FMFIA 230.06
Guidelines 230.07
Planning 230.05, 230.08, 230.11
Reporting 230.06
Test 230.05, 230.13

Misstatements
Budgetary amounts 370.12
DUS sample 480.43
Effects on auditor's report 540.09
Effects on financial statements 480.47, 540.04
Evaluation of misstatements 540.01
Known and likely 540.03
Results of other samples 480.46
Review with management 540.07
Substantive analytical procedures 475.12
Summary of Possible Adjustments . . . . . 540.04, 595 C
Summary of Unadjusted Misstatements . . . . . 540.09, 595 D

Monitoring 260.08, 260.38
Documentation 290.04
Factors for consideration 260.38
IS effects on 260.46
Potential weaknesses . . . . . 295 B
Weaknesses 260.09

Multipurpose testing, Definition of 430.01

Multiple-location audits
Locations to visit . . . . . 285.01, 295 C

Operations, Understanding the entity's
See Understanding the entity's operations

Operations controls
Audit requirements 310.06
Control objectives 330.11
Definition 260.06
Documentation 390.05
Identify for evaluation and testing 275.01
Operations system 320.07
Preliminary assessment of effectiveness 370.13
Reporting requirements 370.13, 580.32

Other accompanying information 100.12, 580.76-.78, 590.02

Overall analytical procedures
Documentation 590.04
Performance 520.01

Overview
See Management's discussion and analysis

Performance measures controls 275.09
See Operations controls

Positions, References to 100.25

Potential misstatements
Accounting applications, Relation to 330.04
Assertions, Relation to 330.02
Control objectives, Relation to . . . . . 395 B
Line item/account, Relation to 330.04
Typical, List of . . . . . 395 B

Preliminary analytical procedures 225.01

Professional judgment 100.23

Related party transactions 280.04, 550.12, 1006

Report on Accountability Report (annual financial statement)
Compliance with laws and regulations 580.62
Dating 580.03
Example, unqualified . . . . . 595 A
Example, various modifications . . . . . 595 B
Financial statements 580.10
Internal controls 580.32
Other information (MD&A [overview], RSSI, required supplementary information and other accompanying information) 580.76
Report format 580.04
Significant matters section 580.06

Report on financial statements
Adverse 580.30
Consistency 580.20
Departure from established accounting principles 580.22
Disclaimer 580.31
Explanatory paragraphs 580.26
Qualified 580.28
Scope limitations 580.15
Uncertainties 580.19
Unqualified 580.24

Representation letter from management
See Management representations

Representation letter, Legal
See Inquiries of attorneys

Representative sampling
See Sampling

Required supplementary stewardship information (RSSI) 100.12, 220.06
580.76-.78, 590.02

Risk
See Audit risk
See Combined risk
See Control risk
See Detection risk
See Fraud risk
See Inherent risk

Risk assessment (as part of an entity's internal control) 260.08, 260.34
Documentation 290.04
Identification 260.09
IS effects on 260.17
Factors for consideration 260.34
Potential weaknesses . . . . . 295 B

Rotation testing of controls . . . . . 380.01, 395 G

Safeguarding controls 260.06, 310.04
See Financial reporting contols

Sampling
Attribute sampling 450.01, 450.06
Classical variables estimation sampling 480.32, 480.45
Control tests 410.01, 450.01
Dollar-unit sampling (DUS) 480.21, 480.43
Evaluation of sample results 450.13, 480.39
Flowcharts and example workpapers . . . . . 495 E
Other sampling methods 480.13, 480.34
Population 450.04, 480.01
Representative selections (sampling) 480.10
Selection methods for detail tests 480.04

Sensitive payments 280.05

Significant cycles/accounting applications
Audit requirements for internal controls 310.06
Documentation 290.05, 390.04
Identifying 240.01
Relationship to line items/accounts 240.03, 330.03

Significant line items, accounts, assertions, and RSSI
Documentation 290.06
Identifying 235.01

Specific control evaluation worksheet (SCE)
Control objectives, Documentation of 330.07
Control activities, Documentation of 340.01, 350.06
Sample completed worksheet . . . . . 395 H

Statistical risk factors . . . . . 480.24, 495 D

Stewardship information
Reporting 580.77
See Required supplementary stewardship information (RSSI)

Subsequent events 550.04, 1005

Substantive analytical procedures 475.01
Considerations for use . . . . . 495 A
Documentation 490.06
Establishment of limit, guidelines 475.05
Increasing effectiveness of 475.14
Investigation of differences 475.06
Levels of 470.05
Performance of 475.04

Substantive tests
Definition 410.01
Determining mix 470.10
Directional testing 470.14
Levels of assurance 470.02
Types of tests 470.03
See Detail tests
See Substantive analytical procedures

Summary of Possible Adjustments . . . . . 540.04, 595 C

Summary of Unadjusted Misstatements . . . . . 540.09, 595 D

Supplemental analytical procedures 470.05, 475.17, 520.03

Understanding the entity's operations 220.01
Accounting issues and policies 220.05
Documentation 290.03
IS 220.07
Sources of information 220.08

User controls
See IS controls

Walkthrough procedures
Control techniques, Operation of 350.08
Processing systems, Understanding of 320.01
Use as limited control test 340.02

Yellow book
See Auditing standards and related OMB guidance