SECTION 300

Internal Control Phase

Contents – Overview of the Internal Control Phase

|  |
| --- |
| Overview FAM   * Overview of the FAM Methodology 110 |
| Planning Phase FAM   * Overview of the Planning Phase 210 * Perform Preliminary Engagement Activities 215 * Understand the Entity’s Operations 220 * Perform Preliminary Analytical Procedures 225 * Determine Materiality 230 * Identify Significant Line Items, Accounts, and Assertions 235 * Identify Significant Accounting Applications, Cycles, and Financial Management Systems 240 * Identify Significant Provisions of Laws, Regulations, Contracts, and Grant Agreements 245 * Identify Relevant Budget Restrictions 250 * Identify Risk Factors 260 * Determine Likelihood of Effective IS Controls 270 * Identify Relevant Operations Controls to Evaluate and Test 275 * Plan Other Audit Procedures 280 * Plan Locations to Visit 285 * Documentation 290 |
| Internal Control Phase FAM   * Overview of the Internal Control Phase 310 * Understand Information Systems 320 * Identify Control Objectives 330 * Identify and Understand Relevant Control Activities 340 * Determine the Nature, Extent, and Timing of Control Tests and Compliance with FFMIA 350 * Test IS Controls, Perform Nonsampling Control Tests, and Test Compliance with FFMIA 360 * Assess Internal Control on a Preliminary Basis 370 * Other Considerations 380 * Documentation 390 |
| Testing Phase FAM   * Overview of the Testing Phase 410 * Design the Nature, Extent, and Timing of Further Audit Procedures 420 * Design Tests 430 * Perform Tests and Evaluate Results 440 * Sampling Control Tests 450 * Compliance Tests 460 * Substantive Procedures -- Overview 470 * Substantive Analytical Procedures 475 * Substantive Detail Tests 480 * Documentation 490 |
| Reporting Phase FAM   * Overview of the Reporting Phase 510 * Perform Overall Analytical Procedures 520 * Reassess Materiality and Risks of Material Misstatement 530 * Evaluate Effects of Misstatements on Financial Statements and Auditor’s Reports 540 * Audit Exposure (Further Evaluation of Audit Risk) 545 * Perform Other Reporting Phase Audit Procedures 550 * Determine Whether Financial Statement Presentation is in Accordance with U.S. GAAP 560 * Determine Compliance with GAO/CIGIE Financial Audit Manual 570 * Draft Reports 580 * Documentation 590 |

310 – Overview of the Internal Control Phase

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

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

The auditor uses results of this internal control work to

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

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

Management, with oversight by those charged with governance or other oversight bodies, sets objectives to meet the entity’s mission, strategic plan, and goals and requirements of applicable laws and regulations. Management groups objectives into one or more of the three categories of objectives: operations, reporting, and compliance. Operations objectives relate to program operations that achieve an entity’s mission. Reporting objectives relate to the preparation of reports for use by the entity, its stakeholders, or other external parties. Reporting objectives may be grouped further into the following subcategories: external financial reporting objectives, external nonfinancial reporting objectives, and internal financial reporting objectives and nonfinancial reporting objectives. Compliance objectives relate to compliance with applicable laws, regulations, contracts, and grant agreements. Entity management is responsible for establishing and maintaining internal control over financial reporting to provide reasonable assurance that the entity’s objectives will be met. In a financial statement audit, the auditor evaluates those internal controls designed to provide reasonable assurance that the following objectives are met.

* **Reliability of financial reporting:** Transactions are properly recorded, processed, and summarized to permit the preparation of the financial statements in accordance with U.S. generally accepted accounting principles (U.S. GAAP), and assets are safeguarded against loss from unauthorized acquisition, use, or disposition.
* **Compliance with provisions of applicable laws, regulations, contracts, and grant agreements:** Transactions are executed in accordance with provisions of applicable laws, including those governing the use of budget authority, regulations, contracts, and grant agreements, noncompliance with which could have a material effect on the financial statements.

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

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

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

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

If the auditor’s understanding is that the control has been designed and implemented effectively, the auditor should test the following types of controls:

* **Financial reporting controls** (including certain **safeguarding** and **budget controls**) for each significant assertion in each significant cycle/accounting application (identified in FAM 240).
* **Compliance controls** for each significant provision of applicable laws, regulations, contracts, and grant agreements identified for testing (see FAM 245), including **budget controls** for each relevant budget restriction (see FAM 250).
* **Operations controls** (1) for data relied on in performing financial audit procedures or (2) selected for testing by the audit team.

The auditor is not required to test controls that have not been designed and implemented effectively. Thus, internal controls that are not effective in design (based on work performed during the design phase of the current year) do not need to be tested. If the auditor determined in a prior year that a control in a particular accounting application was ineffective and if management indicates that the control has not improved, the auditor need not test it in the current year. On the other hand, if controls have been determined to be designed and implemented effectively, the auditor should perform sufficient tests of their effectiveness to support a low assessed level of control risk.

If the auditor expects to disclaim an opinion because of scope limitations, the auditor may limit internal control work to updating the understanding of the design of controls and whether they have been implemented. The auditor may do this by inquiring as to whether previously identified control weaknesses have been corrected. In the year the auditor expects to issue an opinion on the financial statements, the auditor should perform sufficient work on internal control to support the opinion.

In gaining an understanding of an entity’s internal control, including internal control related to information systems, including the related business processes relevant to financial reporting and communication related to services provided by a service organization, the auditor should obtain evidence about the design of relevant controls and whether they have been implemented. In obtaining evidence about whether controls have been implemented, the auditor should determine whether the entity is using them, rather than merely having them written in a manual, for example. This differs from determining a control’s operating effectiveness, which is concerned with how the control was applied; the consistency with which it was applied; and by whom and by what means it was applied, including when applicable whether the person performing the control has the necessary authority and competence to perform it effectively (AU-C 330.10a).

The auditor should obtain an understanding of how the entity uses the services of a service organization in the entity’s operations for assessing risk and planning other audit procedures, including the following:

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

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

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

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

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

OMB audit guidance requires for those service organization controls that are relevant to the audit and have been suitably designed and implemented, service organizations should either (1) provide an audit report (service organization type 2 report) on whether management’s description of the service organization’s system fairly presents the service organization’s system that was designed and implemented throughout the specified period, internal controls were suitably designed to achieve the specified objectives and implemented throughout the specified period, and the controls that were tested were operating effectively to provide reasonable assurance that the related control objectives were met during the period specified or (2) allow user auditors to perform appropriate tests of controls at the service organization. If the service organization report does not exist, or the auditor does not judge the scope of these reports to be sufficient, the auditor should request to perform the work directly or to have the service auditor perform such work.

The service organization auditor may perform substantive procedures for use by the entity auditor. If necessary substantive procedures are not performed by the service organization auditor, the entity auditor should request to perform this work directly. The entity auditor should determine whether sufficient audit evidence has been obtained to meet the audit objectives.

If the auditor is giving an opinion on internal control and is unable to obtain sufficient evidence concerning the effectiveness of internal control, the auditor should qualify the opinion or disclaim an opinion on the entity’s internal control, if applicable, due to a scope limitation, as discussed in FAM 580.34 through .36 and .52 through .54. If the auditor is not providing an opinion on internal control, the auditor should evaluate whether the audit evidence is sufficient for purposes of achieving the audit objectives related to internal control described in the OMB audit bulletin. The auditor also should evaluate whether the scope of the work is sufficient for purposes of meeting the audit objective related to compliance with applicable laws, regulations, contracts, and grant agreements. If the scope is not sufficient, the auditor should report a scope limitation as discussed in FAM 580.84 through .86.

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

* Understand the entity’s design of the information systems for financial reporting; compliance with applicable provisions of laws, regulations, contracts, and grant agreements; and relevant operations (see FAM 320).
* Identify control objectives by assertion (see FAM 330).
* Identify and understand relevant control activities that effectively achieve the control objectives by assertion (see FAM 340).
* Determine whether controls have been implemented and the nature, extent, and timing of control testing (see FAM 350).
* Perform control tests of control effectiveness that do not involve sampling (nonsampling control tests) (see FAM 360).[[4]](#footnote-4) Sampling control tests, if necessary, are performed in the testing phase (see FAM 450).
* On a preliminary basis, based on the evidence obtained, assess (1) the effectiveness of financial reporting, compliance, and relevant operations controls; (2) control risk; and (3) the risk of material misstatement (see FAM 370). The risk of material misstatement includes inherent and control risk and is discussed in FAM 370.09.
* Consider partial-year controls and planned changes in controls (see FAM 380).
* Document the understanding and testing of controls (see FAM 390).

320 – Understand Information Systems

1. The auditor should obtain an understanding of the design of the entity’s information systems (whether automated or manual), including the processes relevant to financial reporting, for processing and reporting of

* accounting, budget, compliance, and operations data and
* maintaining accountability for the related assets, liabilities, equity, and budgetary resources.[[5]](#footnote-5)

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

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

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

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

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

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

Accounting System(s)

1. For each significant cycle and accounting application identified for significant line items and assertions in FAM 240, the auditor should obtain an understanding of and should document the design of

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

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

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

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

Budget Accounting System(s)

1. Through discussions with appropriate entity personnel, the auditor should understand and document the design of the entity’s processes for

* developing and requesting apportionments from OMB;
* establishing and allocating allotments within the entity, including reprogramming of allotments;
* establishing and recording commitments, if applicable;
* establishing, recording, and monitoring obligations (undelivered orders, which include contracts and purchase orders);
* establishing and recording expended authority (delivered orders);
* establishing and recording outlays;
* monitoring supplemental appropriations;
* deobligating excess amounts when orders are completed;
* recording transactions in and adjustments to expired accounts; and
* monitoring canceled (closed) accounts.

Compliance System(s)

1. The compliance system includes the entity’s policies and procedures to monitor compliance with provisions of laws, regulations, contracts, and grant agreements applicable to the entity. Through discussions with appropriate entity personnel, the auditor should understand and document the design of the entity’s process for

* identifying and documenting all laws, regulations, contracts, and grant agreements applicable to the entity;
* monitoring changes in applicable laws, regulations, contracts, and grant agreements and responding on a timely basis;
* establishing policies and procedures for complying with specific laws, regulations, contracts, and grant agreements and clearly documenting and communicating these policies and procedures to appropriate personnel;
* ensuring that an appropriate number of competent individuals at appropriate levels within the entity monitor the entity’s compliance with applicable laws, regulations, contracts, and grant agreements; and
* investigating, resolving, communicating, and reporting any noncompliance with provisions of applicable laws, regulations, contracts, and grant agreements.

Operations System(s)

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

330 – Identify Control Objectives

1. In designing their systems, entities identify control objectives for each type of control that if achieved, would provide the entity with reasonable assurance that individual and aggregate misstatements (whether caused by error or fraud), losses, or noncompliance material to the financial statements would be prevented, or detected and corrected. For social insurance and nonmonetary information in the financial statements, such as physical units of heritage assets, the objectives would relate to controls that would provide reasonable assurance that misstatements, losses, or noncompliance that would be considered material by users of the information would be prevented, or detected and corrected. These control objectives can be classified as follows:

* **Financial reporting controls** to prevent, or detect and correct, misstatements in significant financial statement assertions. These include **safeguarding controls** to safeguard assets against loss from unauthorized acquisition, use, or disposition and **segregation-of-duties controls** to prevent one person from controlling multiple aspects of a transaction, allowing that person to both cause and conceal misstatements whether due to error or fraud.
* **Budget controls** to provide reasonable assurance that the entity (1) properly records, processes, and summarizes transactions to permit the preparation of the statement of budgetary resources and reconciliation of net cost to budget note disclosure in accordance with U.S. GAAP and (2) executes transactions in accordance with budget authority.
* **Compliance controls** to comply with significant provisions of applicable laws, regulations, contracts, and grant agreements.
* **Operations controls** to achieve the performance desired by management for planning, productivity, quality, economy, efficiency, or effectiveness of the entity’s operations.

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

Financial Reporting Controls

1. The auditor should evaluate and test **financial reporting controls** for each significant assertion in each significant financial statement line item or account, including related disclosures if the auditor has determined that controls have been designed and implemented effectively. (See FAM 235.02 for a discussion of financial statement assertions.) The first step in identifying control objectives for financial reporting controls is to consider the types of misstatements that might occur in each significant assertion in each significant line item or account. One or more potential misstatements can occur in each financial statement assertion. For example, for the existence or occurrence assertion, potential misstatements can occur in four areas.

* **Occurrence/validity:** Recorded transactions and events do not represent economic events that actually occurred that pertain to the entity.
* **Cutoff:** Transactions are recorded in the current period, but the related economic events occurred in a different period.
* **Summarization:** Transactions are summarized improperly, resulting in an overstated total.
* **Substantiation:** Recorded assets and liabilities of the entity do not exist at a given date.

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

Identifying Potential Misstatements and Control Objectives

As discussed in FAM 240, the auditor identifies the significant accounting applications that provide the source of significant entries to each significant line item or account. Each significant line item or account is affected by input from one or more accounting applications. Accounting applications are classified as (1) transaction related or (2) line item/account related. For example, as illustrated in FAM 395 A, sources of significant entries to cash typically include the cash receipts (transaction related), cash disbursements (transaction related), payroll (transaction related), and cash (line item/account related) accounting applications, while sources of significant entries to accounts receivable typically include the billing (transaction related), cash receipts (transaction related), and accounts receivable (line item/account related) accounting applications. The auditor should identify the accounting applications in the cycle matrix and Line Item Risk Analysis (LIRA) form, or equivalent documentation.

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.

To understand the effect of potential misstatements as discussed in FAM 330.04, the auditor may consult table 330 regarding transaction-related accounting application assertions as they affect line items/account assertions.

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

| Transaction-related accounting application assertion | Line item/account assertions affected |
| --- | --- |
| 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 |
| Accuracy/valuation | * Accuracy/valuation |

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

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

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

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

Budget Controls

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

Compliance Controls

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

Operations Controls

1. The objectives of **operations controls** are to provide reasonable assurance that the entity effectively and efficiently meets its mission. The auditor should identify control objectives for any operations controls identified for testing and may document operations control objectives in a separate SCE worksheet for operations controls, in a memo, or incorporate them into an SCE worksheet with related financial reporting controls.

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

340 – Identify and Understand Relevant Control Activities

1. For each control objective, based on discussions with entity personnel and the results of other procedures performed, the auditor should identify the control activities for achieving the specific control objective.[[6]](#footnote-6) These control activities may be designed by management and may also include control activities designed and implemented by a service organization used by the entity. The auditor should determine whether the control activities identified are dependent on information system processing. A dependency on information system processing exists if a control activity cannot reasonably be expected to achieve a specific control objective without effective information system processing—either in the performance of the control activity or in the production of information used in the performance of the control activity. The auditor may indicate these controls in the auditor’s informal notes and/or interview write-ups for use in the following procedures, but the auditor need not formally document them in the SCE worksheet at this time. The auditor should then identify those that are effective in design to test. Due to the technical nature of many IS controls, the auditor generally should obtain assistance from an IS controls auditor in understanding the entity’s use of information systems and in planning, directing, or performing audit procedures related to assessing IS controls. For example, an IS controls auditor may assist the auditor in identifying and understanding the design of application controls and general controls implemented at the entitywide, system, and application levels that help ensure the effective operation of the control activities that are dependent on information system processing. Additionally, an information technology specialist may assist the auditor in understanding technical aspects of information systems and IS controls. As discussed in FAM 350, the auditor should use walk-throughs, inquiry, and observation to determine whether the entity has implemented these controls identified for further audit procedures. The auditor should use FAM 640 if an entity uses a service organization.

Basic Understanding of Effectiveness of Control Activities

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

Factors to Consider

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

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

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

1. **Directness** refers to the extent to which a control activity relates to a control objective. The more direct the relationship, the more effective that activity may be in achieving the objective. For example, management reviews of inventory reports that summarize the inventory by storage facility may be less effective in preventing, or detecting and correcting, misstatements in the existence assertion for inventory than a periodic physical inventory, which is more directly related to the existence assertion.
2. **Selectivity** refers to the magnitude of the amount, or the significance of other criteria or distinguishing characteristics, that a specific control will identify as an exception condition. Examples of selectivity thresholds are (1) a requirement for additional approvals of all payments to vendors in excess of $25,000 and (2) management reviews of all payments to vendors not on an entity’s approved vendor list. When determining whether a control is likely to be effective, the auditor should evaluate the likelihood that items that do not meet the selectivity threshold could, in the aggregate, result in material misstatements of financial statements; material noncompliance with budget authority; material noncompliance with significant provisions of applicable laws, regulations, contracts, and grant agreements; or significant ineffective or inefficient use of resources.

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

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

* **Frequency of application:** This refers to the regularity with which controls are applied. Generally, the more frequently a control is applied, the greater the likelihood that it will be effective.
* **Authority and competence of personnel (AU-C 330.10a):** This refers to whether the person applying a control has the necessary authority and competence to properly apply it. If the person has less experience and skills or does not have the appropriate authority, it is less likely that the control will be effective. Also, the effective application of a control is generally adversely affected if the technique (1) is performed by an employee who has an excessive volume of work or (2) is not performed carefully.

1. **Follow-up** refers to the procedures performed when a control identifies an exception condition. A control’s effectiveness depends on the effectiveness of follow-up procedures. To be effective, an entity needs to (1) apply these procedures on a timely basis, (2) determine whether control exceptions represent misstatements, and (3) correct all misstatements noted. For example, as a control, an accounting system may identify and put exception transactions into a suspense file or account. Lack of timely follow-up procedures by the entity to (1) reconcile and review the suspense file or account and (2) correct items in the suspense file or account would render the control ineffective.

When evaluating whether controls are likely to be effective, the auditor should evaluate whether the controls also are applied effectively to adjustments/corrections made to the financial records. Such adjustments/corrections may occur at the transaction level, or during summarization of the transactions, or may be posted directly to the general ledger accounts. Further, the auditor should also evaluate the design and implementation of controls applied to the financial statement preparation process.

Based on the understanding of the design of control activities and the determination of whether they are likely to achieve the control objectives, the auditor should assess control risk to decide whether to test controls. If control risk is high for a relevant assertion because the control activities for the related accounting application are not effective in design or likely to be effective in implementation (based on prior years’ testing of the control activities, and the results of procedures performed in the current year to understand the controls, including management’s indication that the controls have not improved from the prior year), the auditor does not need to test the operating effectiveness of the controls in the current year. According to OMB audit guidance, for those controls that have been suitably designed and implemented, the auditor will perform sufficient tests of such controls to conclude whether the controls are operating effectively (i.e., sufficient tests of controls to support a low level of assessed control risk). Thus, the auditor should not elect to forgo control tests because it is more efficient to extend substantive and compliance audit procedures. Further, as discussed in FAM 350.07 through .09, the auditor generally should test only the control activities that are necessary to achieve the objective.

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

1. For each control objective, the auditor should

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

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

1. As noted in FAM 310.02, OMB audit guidance requires the auditor to perform sufficient tests of internal controls that have been suitably designed and implemented to conclude whether the controls are operating effectively (i.e., sufficient tests of controls to support a low level of assessed control risk). Thus, the auditor should not elect to forgo control tests solely because it is more efficient to extend substantive and compliance audit procedures.
2. For Chief Financial Officers (CFO) Act agencies, the auditor also should determine the nature, extent, and timing of tests for determining whether the entity’s financial management systems are in substantial compliance with federal financial management systems requirements (these requirements are established by the Department of the Treasury (Treasury) and published in the *Treasury Financial Manual* (TFM), volume 1, chapter 9500); federal accounting standards (U.S. GAAP—see FAM 560); and the SGL at the transaction level in order to report in accordance with FFMIA.

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

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

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

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

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

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

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

Identify Relevant Control Activities to Potentially Test

1. For each control objective identified in FAM 330, the auditor should identify the control activity, or combination of control activities, that is likely to (1) achieve the control objective and (2) improve the efficiency of control tests. In doing this, the auditor should consider (1) the extent of any inherent risk[[7]](#footnote-7) and control environment, entity risk assessment, communication, or monitoring weaknesses,[[8]](#footnote-8) including those related to information systems (as documented in the LIRA form and/or audit strategy document, or equivalent (see FAM 260)), and (2) the tentative determination of the likelihood that IS controls will be effective (see also FAM 270).

The auditor generally should test only the control activities necessary to achieve the objective. For example, the entity may have several controls that are equally effective in achieving an objective. In such a case, the auditor generally should test the control activity that is efficient to test, considering such factors as (1) the extent to which a control achieves several control objectives and thereby reduces the number of controls that would ordinarily need to be tested; (2) the time that will be required to test the control; and (3) control dependencies, particularly for IS controls. A control dependency exists when the effectiveness of an internal control is dependent on the effectiveness of other internal controls. For example, when a dependency on information system processing exists, a control activity cannot reasonably be expected to achieve a specific control objective without effective information system processing—either in the performance of the control activity or in the production of information used in the performance of the control activity. Due to the technical nature of many IS controls, the auditor generally should obtain assistance from an IS controls auditor in understanding the entity’s use of information systems and in planning, directing, or performing audit procedures related to assessing IS controls. For example, an IS controls auditor may assist the auditor in identifying and understanding the design of application controls and general controls implemented at the entitywide, system, and application levels that help ensure the effective operation of the control activities that are dependent on information system processing. Additionally, an information technology specialist may assist the auditor in understanding technical aspects of information systems and IS controls. See also FAM 360. The auditor may also, based on risk, test different control activities from year to year in a recurring audit, but it does not change the auditor’s responsibility to identify the control activity, or combination of control activities, in the current-year audit that are necessary to achieve the control objective.

1. For those control objectives for which the auditor preliminarily determines that effective control activities have been designed and implemented effectively to achieve the control objective, the auditor should test the selected control activities, as discussed in FAM 360 and FAM 450. The auditor may test all or only certain control activities (because others are not likely to be effective), related to a control objective. Per OMB audit requirements for federal financial statements, the auditor should **not** elect to forgo control tests solely because it is more efficient to extend substantive or compliance audit procedures.

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

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

Perform Walk-throughs to Determine Whether Controls Have Been Implemented

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

### Document Control Activities to Be Tested

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

Determine the Nature of Control Tests

1. To obtain additional sufficient, appropriate evidence of the effectiveness of specific controls, the auditor should determine the combination of control tests (**observation, inquiry, inspection,** or **reperformance**) to be performed. No one specific control test is always necessary, applicable, or equally effective in every circumstance. In designing and performing tests of controls, the auditor should perform other audit procedures in combination with inquiry to obtain sufficient, appropriate audit evidence regarding the operating effectiveness of controls, including how the controls were applied at relevant times during the period under audit; the consistency with which they were applied; and by whom or by what means they were applied, including, when applicable, whether the person performing the control possesses the necessary authority and competence to perform the control effectively (AU-C 330.10). The auditor should determine whether the controls to be tested depend upon other controls and, if so, whether it is necessary to obtain audit evidence supporting the operating effectiveness of those controls (AU-C 330.10.b). For example, when the auditor decides to test the effectiveness of a user review of exception reports detailing sales in excess of authorized credit limits, the user review and related follow up is the control that is of direct relevance to the auditor. In addition to obtaining audit evidence to support the completeness and accuracy of the exception reports, in this example, it may be necessary to obtain audit evidence supporting the general information technology controls (AU-C 330.A33). See FAM 340.03 for the factors to consider when evaluating whether controls are likely to achieve the control objective. In determining the types of tests to apply, the auditor should determine the tests that are effective and efficient, as discussed in FAM 350.16 through .19. Specific types of control tests and methods to apply them are discussed in the following paragraphs.
2. **Observation.** The auditor conducts observation tests by observing entity personnel actually performing control activities in the normal course of their duties. Observation generally provides highly reliable evidence that a control activity is properly applied when the auditor is there to observe it. However, it provides no evidence that the control was in operation at any other time. Consequently, the auditor should supplement observation tests with corroborative evidence obtained from other tests (such as **inquiry** and **inspection**) about the operation of controls at other times.
3. **Inquiry.** The auditor conducts inquiry tests by making either oral or written inquiries of entity personnel involved in the application of specific control activities to determine what they do or how they perform a specific control activity. Such inquiries are typically open ended. Evidence obtained from inquiry alone is not sufficient; thus, the auditor should supplement inquiry with other types of control tests—**observation** or **inspection** (which may include reperformance). Combining inquiry with inspection or reperformance typically provides more assurance than inquiry combined only with observation. The reliability of evidence obtained from inquiry depends on various factors, including the following:

* The competence, experience, knowledge, independence, and integrity of the person of whom the inquiry was made. The reliability of evidence is enhanced when the person possesses these attributes.
* Whether the evidence was general or specific. Evidence that is specific is usually more reliable than evidence that is general.
* The extent of corroborative evidence obtained. Evidence obtained from several entity personnel is usually more reliable than evidence obtained from only one person.
* Whether the evidence was provided orally or in writing. Generally, evidence provided in writing is more reliable than evidence provided orally.

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

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

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

The auditor should select the type of control tests based on (1) the nature of the control to be tested and (2) the timing of the test and period covered by the control.

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

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

Determine the Extent of Control Tests

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

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

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

Determine the Timing of Control Tests

The auditor should determine when to perform control tests. For efficiency, the auditor may perform most control testing on an interim basis that covers 9 or 10 months of the audit period and perform a roll-forward and limited testing for the remaining audit period. The auditor should obtain evidence about significant changes to those controls subsequent to the interim period (AU-C 330.12). Another approach is for the auditor to determine the actual population of transactions for the audit period through an interim date and estimate the transactions for the remaining audit period. A statistical sample can then be drawn that covers the entire audit period, with the bulk of testing completed during the interim period and the remaining items tested immediately after year-end. The auditor generally should overestimate the remaining items in the population so every item will have a chance of selection. An underestimate by the auditor would leave some items outside the population sample and not subject to audit sampling, although they may be tested in other ways.

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

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

If the auditor believes it is likely that the opinion on the financial statements will be unmodified (or that modifications will not relate to the entity’s ability to prepare reliable financial statements or provide reliable financial information when needed), that internal control will be determined to be effective, and that the auditor will find no instances of noncompliance with legal and regulatory requirements, then the auditor should test the financial management systems’ substantial compliance with the three FFMIA requirements. Also, the auditor may test for the systems’ substantial compliance with the FFMIA requirements in other circumstances, as discussed in FAM 350.06.

When the auditor tests systems’ substantial compliance with the FFMIA requirements, as discussed in FAM 350.04, the auditor generally should perform these tests concurrently with control tests described in FAM 360. The issues relevant to determining the nature, extent, and timing of control tests discussed in the FAM also apply to tests of systems’ compliance with the FFMIA requirements.

The auditor should read any management-developed documentation for its assertion about the systems’ conformance with systems requirements in its FMFIA section 4 report[[9]](#footnote-9) and any work it may have done for FFMIA compliance as described in OMB Circular No. A-123.

Management’s documentation may be the basis for tests of the systems’ substantial compliance with the three FFMIA requirements. If, for example, management provides the auditor with a checklist detailing the functions the systems are able to perform, the auditor generally should select some significant functions from the checklist and determine whether the systems actually perform them. The auditor may do this based on knowledge the auditor has acquired from gaining an understanding of the systems, as well as by additional observation, inquiry, inspection, and walk-throughs for control tests.

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

Test the Components of Internal Control over Financial Reporting

The auditor should identify and test those controls that are important to the auditor’s conclusion about whether the entity has effective internal control over financial reporting (for integrated audits, also see AU-C 940.22) or for the report on internal control over financial reporting. The auditor generally should test the controls by a combination of observation, inquiry, or inspection. Per AU-C 940.A34, the auditor’s evaluation of entity-level controls can result in increasing or decreasing the testing that the auditor otherwise would have performed on other controls. However, the approach documented in the FAM does not allow for decreasing the amount of testing based solely on the evaluation of entity-level controls.

1. The auditor should evaluate the components of internal control over financial reporting and determine whether (1) the components are designed, implemented, and operating effectively and (2) the components are operating together in an integrated manner to achieve the entity’s financial reporting objectives (for integrated audits, also see AU‑C 940.23).The auditor assesses the five components and 17 related principles in the *Standards for Internal Control in the Federal Government* (known as the Green Book). In general, all components and principles are relevant for establishing an effective internal control system. See FAM 260 for additional discussion of the five components and 17 related principles of internal control. In rare circumstances, there may be an operating or regulatory situation in which management has determined that a principle is not relevant for the entity to achieve its objectives and address related risks. If management determines that a principle is not relevant, management should support that determination with documentation that includes the rationale of how, in the absence of that principle, the associated component could be designed, implemented, and operating effectively.

Control Environment

The following principles are relevant to the auditor’s evaluation of whether the control environment is designed, implemented, and operating effectively to achieve the entity’s financial reporting objectives:

* The oversight body and management demonstrate a commitment to integrity and ethical values. An example of a procedure to perform in order to determine whether the oversight body and management have established an appropriate ethical tone and sound integrity and ethical values is to review the entity’s policies, directives, and guidelines on ethical behavior and standards of conduct.
* The oversight body oversees the entity’s internal control over financial reporting.
* Management establishes an organizational structure, assigns responsibility, and delegates authority to achieve the entity’s financial reporting objectives.
* Management demonstrates a commitment to recruit, develop, and retain competent individuals in alignment with the entity’s financial reporting objectives.
* Management evaluates performance and holds individuals accountable for their internal control over financial reporting responsibilities.

Risk Assessment

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

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

Control Activities

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

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

Information and Communication

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

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

Monitoring Activities

The following principles are relevant to the auditor’s evaluation of whether the entity’s monitoring activities are designed, implemented, and operating effectively to achieve the entity’s financial reporting objectives:

* Management establishes and operates monitoring activities to monitor the internal control system and evaluate the results.
* Management should remediate identified deficiencies in internal control over financial reporting on a timely basis.

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

1. As discussed in FAM 350, the auditor should perform tests of operating effectiveness for those controls that the auditor determined are designed and implemented effectively. (See FAM 380.02 if control activities are not effective in design during the entire audit period.) The auditor generally should

* request assistance from an IS controls auditor to test IS controls (FAM 360.03 through .10);
* perform nonsampling control tests (the auditor generally should perform sampling control tests in the testing phase, as discussed in FAM 450—also see FAM 360.12 through.14); and
* evaluate the results of nonsampling control tests (FAM 360.15 through .16).

The auditor also should design and conduct tests of the financial management systems’ substantial compliance with the three requirements of FFMIA, if the auditor determines that such tests are necessary (see FAM 350.03 through .06 and 350.24 through .26). Many nonsampling control tests can also serve as tests for substantial compliance with the FFMIA requirements, especially the systems requirements and the SGL, although testing for accounting standards (U.S. GAAP) will include substantive procedures, done as part of the testing phase. After testing, the auditor may make a preliminary conclusion as to whether the entity’s financial management systems comply substantially with the FFMIA requirements (see FAM 360.17).

Test IS Controls

In the planning phase, the auditor identifies and documents the control activities included in the significant accounting applications that are dependent on information system processing. Such controls are often application and user controls. The auditor then identifies and documents the general controls implemented at the entitywide, system, and application levels that help ensure the effective operation of application and user controls included in the significant accounting applications. See FAM 240 for the specific requirements. The auditor also obtains an understanding of the design of the general controls identified to conclude tentatively whether IS controls are likely to be effective. See FAM 270 for the specific requirements. In the internal control phase, the auditor identifies the specific internal control activities that are likely to achieve the identified control objectives. See FAM 330, 340, and 350 for the specific requirements.

As discussed in FAM 330.07, the auditor may use an SCE worksheet or equivalent to document the procedures discussed in FAM 330.03 through .06. The SCE worksheet groups potential misstatements and control objectives by accounting application (within each cycle), providing a format for performing and documenting the evaluation and testing of internal controls efficiently. For each of the specific controls to be evaluated and tested, as documented on the SCE worksheet or equivalent document, the auditor should distinguish which are IS controls. IS controls included on the SCE worksheet or equivalent document are often application and user controls. FAM 295 F provides more detail on the three types of information system controls—general controls, application controls, and user controls. As discussed in FAM 295 F, the effectiveness of user controls typically depends on information system processing or the reliability of information that information systems produce.

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

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

As discussed in FAM 350.07, the auditor generally should test only the control activities necessary to achieve the objective. For example, the entity may have several controls that are equally effective in achieving an objective. In such a case, the auditor generally should test the control activity that is efficient to test, considering such factors as (1) the extent to which a control achieves several control objectives and thereby reduces the number of controls that would ordinarily need to be tested; (2) the time that will be required to test the control; and (3) control dependencies, particularly for IS controls. A control dependency exists when the effectiveness of an internal control is dependent on the effectiveness of other internal controls. For example, when a dependency on information system processing exists, a control activity cannot reasonably be expected to achieve a specific control objective without effective information system processing—either in the performance of the control activity or in the production of information used in the performance of the control activity. An IS controls auditor may assist the auditor in identifying and understanding the design of application controls and general controls implemented at the entitywide, system, and application levels that help ensure the effective operation of the control activities that are dependent on information system processing. The auditor may also, based on risk, test different control activities from year to year in a recurring audit, but it does not change the auditor’s responsibility to identify the control activity, or combination of control activities, in the current-year audit that are necessary to achieve the control objective.

The auditor should document conclusions on the effectiveness of IS controls during the audit period. Due to the technical nature of many IS controls, the auditor generally should obtain assistance from an IS controls auditor in understanding the entity’s use of information systems and in planning, directing, or performing audit procedures related to assessing IS controls. Additionally, an information technology specialist may assist the auditor in understanding technical aspects of information systems and IS controls.

If the auditor identifies IS controls on the SCE, the auditor should evaluate the effectiveness of related

* general controls at the entity-wide and system levels;
* general controls at the application level; and
* specific application controls, such as business process application controls, interface controls, data management system controls, and/or user controls, unless the IS controls that achieve the control objectives are general controls.

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

The auditor should determine whether entity-wide and system-level general controls are designed, implemented, and operating effectively by

* identifying applicable general controls;
* determining how those controls function, and whether they have been implemented; and
* evaluating and testing the effectiveness of the identified controls.

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

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

The auditor may test general controls through a combination of procedures, including observation, inquiry, inspection (which includes a review of documentation on systems and procedures), and reperformance using appropriate test software. Although sampling is generally not used to test general controls, the auditor may use sampling to test certain controls, such as those involving approvals.

1. If general controls are not designed, implemented, or operating effectively, the auditor will generally be unable to obtain satisfaction that application controls are effective.[[10]](#footnote-10) In such instances, the auditor should (1) determine and document the nature and extent of risks resulting from ineffective general controls, (2) identify and test any manual controls that achieve the control objectives that the IS controls in the SCE worksheet or equivalent document were unable to achieve, and (3) see FAM 580 for classifying and reporting control deficiencies.

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

Tests of General Controls at the Application Level

If the auditor reaches a favorable conclusion on general controls at the entity-wide and system levels, the auditor should evaluate and test the effectiveness of general controls for those software programs, or applications, within which application controls or user controls are to be tested. Due to the technical nature of many IS controls, the auditor generally should obtain assistance from an IS controls auditor in assessing these controls.

1. If general controls are not operating effectively within the application, application controls and user controls generally will be ineffective.[[11]](#footnote-11) In such instances, the audit team should discuss the nature and extent of risks resulting from ineffective general controls. The auditor should determine whether to proceed with the evaluation of application controls and user controls.

Tests of Application Controls and User Controls

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

Perform Nonsampling Control Tests

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

Some important controls do not operate frequently, but the auditor may need to test these controls. For example, some controls may be performed only once a year, such as controls over the year-end closing process, and can only be tested once. Still other controls may operate biweekly or weekly, such as controls over processing the payroll that may operate 26 or 52 times a year. Table I below provides guidance in the testing of small populations associated with less frequently operating controls. For less frequently operating controls, the effect of other sources of evidence is often greater than for more frequently operating controls. Some examples of other implicit sources of evidence in an audit of the financial statements include inherent risk assessments, assessments of design and implementation, past experience, walk-throughs, corroborating inquiries, other control testing, knowledge about other balances, competence of personnel, systems knowledge, etc.

Table I: Testing Operating Effectiveness of Small Populations

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

Perform Segregation-of-Duties Control Tests

Segregation-of-duties controls are designed to reduce the opportunities for any person to be in a position both to perpetrate and to conceal misstatements, especially fraud, in the normal course of duties. Typically, an entity achieves adequate segregation of duties by establishing controls (such as segregating asset custody from recordkeeping functions) to prevent any person from having uncontrolled access to both assets and related records.

The auditor should test segregation of duties in the situations described in FAM 330.08. The auditor may use the following procedures to test segregation-of-duties controls:

1. Identify the assets to be controlled through the segregation of duties.
2. Identify the individuals who have authorized access (direct or indirect) to the assets. An individual with direct access is authorized to handle the assets directly (such as during the processing of cash receipts). An individual with indirect access is authorized to prepare documents that cause the release or transfer of assets (such as preparing the necessary forms to request a cash disbursement or transfer of inventory).
3. For each individual with authorized access to assets, determine whether there are sufficient asset access controls. Asset access controls are those controls that are designed to provide assurance that actions taken by individuals with authorized access to assets are reviewed and approved by other individuals. For example, an approval of an invoice for payment generally provides asset access controls (relating to cash) over those individuals authorized to prepare supporting documentation for the transaction. If information systems provide access to assets, the auditor should design tests of IS controls to identify (1) individuals (including information systems personnel) who may use the computer to obtain access and (2) asset access controls over such individuals.
4. For individuals with authorized access to assets over which asset access controls are insufficient, determine whether such individuals can affect any recording of transactions in the accounting records. If so, segregation of duties is insufficient, unless such access to accounting records is controlled. For example, the person who processes cash receipts may also be able to record entries in the accounting records. Such a person may be in a position to manipulate the accounting records to conceal a shortage in the cash account, unless another individual reviews all accounting entries that the person made (or should have been made).

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

Evaluate the Results of Nonsampling Control Tests

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

Additionally, the auditor should gather sufficient evidence to report the control deficiency, as discussed in FAM 580.44 through .72.

Test Compliance with FFMIA

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

370 – Assess Internal Control on a Preliminary Basis

1. Based on the evaluation of the design and implementation of internal control and the results of nonsampling control tests, the auditor should preliminarily assess the effectiveness of internal control during the period (for a report on internal control and for determining the risk of material misstatement used to determine the nature, extent, and timing of further audit procedures) and as of the end of the period (if the auditor is expressing an opinion on internal control as of that point in time). Assessing the effectiveness of IS controls is discussed in FAM 370.03 through .05. Assessing the effectiveness of each type of control—financial reporting (including safeguarding), budget, compliance, and operations—is discussed in FAM 370.06 through .14.

To assess the effectiveness of internal control, the auditor determines whether internal control provides reasonable assurance that control objectives are achieved. Internal control only provides reasonable assurance that misstatements, losses, or noncompliance, material in relation to the financial statements, would be prevented, or detected and corrected, during the period under audit. For each control objective that is not achieved, the auditor should obtain sufficient (1) information to determine whether the deficiency is a material weakness, significant deficiency, or other control deficiency and to report any deficiencies in the auditor’s report or separate management report (see FAM 580.44 through .72) and (2) evidence to support the preliminary assessment of the effectiveness of internal control and the risk of material misstatement.

Information System Results

Due to the technical nature of many IS controls, the auditor generally should obtain assistance from an IS controls auditor in assessing these controls. Based on the procedures performed, the auditor and IS controls auditor should discuss conclusions on the effectiveness of IS controls and reach agreement. The auditor should (1) incorporate the conclusions into the audit documentation for each IS control tested and (2) perform tests on the manual aspects of application controls (e.g., manual follow-up on items in an exception report).

If the auditor determines that IS controls are effective, the auditor may also ask the IS controls auditor to identify any IS controls within the software programs, or applications, tested that the auditor did not previously identify using the above procedures. For example, such IS controls might achieve control objectives not otherwise achieved through manual controls or might be more efficient or effective to test than manual controls.

The IS controls auditor may assist the auditor in determining the efficiency and effectiveness of searching for and testing additional IS controls. The auditor should document these decisions, including a description of the expected nature, extent, and timing of the IS controls auditor’s work.

The auditor and IS controls auditor should work together to document the procedures for evaluating and testing the effectiveness of IS controls and the results of this work.

### Financial Reporting Controls

1. Based on audit procedures performed but before sampling control tests,[[12]](#footnote-12) if any, the auditor generally should form a preliminary conclusion about (1) the effectiveness of financial reporting controls as of the end of the period—when the auditor is providing an opinion on internal control—and (2) the assessed level of control risk and the risk of material misstatement during the period for each significant assertion in each significant line item or account. The risk of material misstatement is the risk that prior to the application of substantive audit procedures, a material misstatement exists in a financial statement assertion.

The risk of material misstatement consists of the risks that (1) a financial statement assertion is susceptible to material misstatement (inherent risk) and (2) such material misstatement, either individually or when aggregated with other misstatements, is not prevented, or detected and corrected, on a timely basis by the entity’s internal control (control risk). The auditor uses professional judgment in assessing inherent risk, control risk, and the risk of material misstatement.

1. **Preliminary assessment of control risk.** For **each significant assertion** in each significant line item or account, the auditor should assess control riskat one of three levels:

* **Low:** The auditor believes that controls **will** prevent or detect any aggregate misstatements in excess of performance materiality that could occur in the assertion.
* **Moderate:** The auditor believes that controls **will more likely than not** prevent or detect any aggregate misstatements in excess of performance materiality that could occur in the assertion.
* **High:** The auditor believes that controls **will more unlikely than likely** prevent or detect any aggregate misstatements in excess of performance materiality that could occur in the assertion.

In assessing control risk in a line item/account assertion, the auditor generally should consider the aggregate magnitude of misstatements that might not be prevented, or detected and corrected, in significant accounting applications that affect the line item or account. For example, the cash receipts, cash disbursements, and payroll accounting applications typically affect the cash account. Accordingly, the auditor should evaluate the risk that aggregate misstatements could arise from a combination of those accounting applications and not be prevented, or detected and corrected, by controls.

1. **Preliminary assessment of the risk of material misstatement.** In assessing the risk of material misstatement, the auditor should evaluate the likelihood that a material misstatement would occur (inherent risk) and not be prevented or detected on a timely basis by the entity’s internal control (control risk). The auditor should base this preliminary assessment of the risk of material misstatement on the auditor’s assessment of inherent risk and control risk. For **each significant assertion** in each significant account, the auditor should assess **the risk of material misstatement** at one of three levels:

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

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

Budget Controls

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

Compliance Controls

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

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

If compliance controls are effective in preventing, or detecting and correcting, noncompliance with significant provisions of applicable laws, regulations, contracts, and grant agreements during the period, the extent of compliance testing can be less than if such controls were not effective, as discussed in FAM 460.

Operations Controls

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

Reevaluation of Control Risk and the Risk of Material Misstatement

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

380 – Other Considerations

Partial-Year Controls

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

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

Planned Changes in Controls

The auditor may become aware of an entity’s plans to implement new accounting or control systems after the audit period ends. Even though new systems or controls are planned, the auditor should evaluate IS controls over the systems in operation to conclude on whether they are designed, implemented, and operating effectively through the end of the audit period to

* assess the risk of material misstatement;
* determine the nature, extent, and timing of further audit procedures;
* provide support for the report or opinion on internal controls; and
* recommend any improvements to the current system that should be considered in designing the new systems or controls.

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

390 – Documentation

1. In addition to preparing an audit plan with control testing audit procedures and other documentation relevant to the internal control phase, the auditor should prepare the documents described in FAM 390.05 through .08 or their equivalent.

The auditor may prepare written guidance for the rest of the audit team, either within or accompanying the audit procedures, to explain possible exceptions, their nature, and why they might be important. This also may help the auditor focus on key matters, more readily determine which exceptions are important, and identify significant exceptions.

The auditor also should document the results of the audit procedures performed and the audit evidence obtained.

As the audit work is performed, the auditor may become aware of possible significant deficiencies or other matters that should be communicated to the entity, including those charged with governance. The auditor should document and communicate these as described in FAM 290.02 and FAM 580.63 through .72.

Cycle Memorandums and Flowcharts

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

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

**A cycle memorandum**

* identifies the cycle transactions, each significant accounting application, and each significant financial management system included in the cycle;
* documents the auditor’s understanding of the information system processing included in the significant accounting applications, including the organizational units and financial management systems involved;
* describes relationships with other cycles;
* identifies financial statement line items, relevant assertions, and general ledger accounts included in the cycle;
* describes the operating policies and procedures relating to the processing of cycle transactions (see FAM 320.03);[[13]](#footnote-13) and
* identifies major internal controls (overview only).

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

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

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

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

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

SCE Worksheet

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

Updating the LIRA Form

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

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

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

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

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

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

| Assertion | Potential misstatement | Control objective |
| --- | --- | --- |
| Existence or occurrence | Transaction related | |
| Occurrence/validity: |  |
|  | 1. Recorded transactions and events do not represent economic events that actually occurred or do not pertain to the entity. | 1a. Recorded transactions, underlying events, and related processing procedures are authorized by federal laws, regulations, contracts, and grant agreements and management policy. |
|  | 1b. Appropriate individuals approve recorded transactions in accordance with management’s general or specific criteria. |
|  |  | 1c. Recorded transactions represent events that actually occurred, are properly classified, and pertain to the entity. |
|  | 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 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 is not overstated. |
| Existence or occurrence | Line item/account related | |
| Substantiation: |  |
|  | 4. Recorded assets and liabilities do not exist at a given date. | 4a. Recorded assets and liabilities exist at a given date. |
|  | 4b. Recorded assets and liabilities of the entity, at a given date, are supported by appropriate detailed records that are accurately summarized and reconciled to the account balance. |
|  |  | 4c. Access to assets, critical forms, records, and processing and storage areas is permitted only in accordance with laws, regulations, and management policy. |
| Completeness | Transaction related | |
|  | Transaction completeness: |  |
|  | 5. Valid transactions are not recorded or are improperly classified. | 5. All valid transactions are recorded and classified properly. |
|  | 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 are recorded as transactions in the current period. |
|  | Summarization: |  |
|  | 7. Transactions are summarized improperly, resulting in an understated total. | 7. The summarization of recorded transactions is not understated. |
| Completeness | Line item/account related | |
|  | Account completeness: |  |
|  | 8. Assets and liabilities of the entity exist but are omitted from the financial statements. | 8. All accounts, assets, and liabilities that exist as of the reporting date that belong in the financial statements are included in the financial statements. There are no undisclosed assets or liabilities. |
| Accuracy/ valuation | Transaction related | |
| Accuracy: |  |
|  | 9. Transactions are recorded at incorrect amounts. | 9. Transactions are recorded at correct amounts. |
|  | Line item/account related | |
|  | Valuation: |  |
|  | 10. Assets and liabilities included in the financial statements are valued on an inappropriate basis. | 10. Assets and liabilities included in the financial statements are 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 are measured properly. |
| Rights and obligations | Line item/account related | |
| Ownership: |  |
|  | 12. Recorded assets are owned by others because of sale, consignment, or other contractual arrangements. | 12. The entity owns (i.e., has valid title to) recorded assets. |
| Rights and obligations | Line item/account related | |
| Rights: |  |
| 13. The entity does not have certain rights to recorded assets because of liens, pledges, or other restrictions. | 13. The entity has the rights to recorded assets at a given date. |
|  | Obligations: |  |
|  | 14. The entity does not have an obligation for recorded liabilities at a given date. | 14. Liabilities are the entity’s obligations at a given date. |
| Presentation and disclosure | Line item/account related | |
| Account classification: |  |
| 15. Accounts or the transactions they accumulate are not properly classified and described in the financial statements. | 15. Accounts and all the transactions they accumulate are properly classified and described in the financial statements. |
|  | Consistency: |  |
|  | 16. The current period financial statement components are based on accounting principles different from those used in the prior periods presented. | 16. The financial statement components are based on accounting principles that are applied consistently from period to period. |
| Presentation and disclosure | Line item/account related | |
| Disclosure: |  |
| 17. Information needed for fair presentation in accordance with U.S. generally accepted accounting principles (U.S. GAAP) is not disclosed in the financial statements or in the related footnotes.[[14]](#footnote-14) | 17. The financial statements and related footnotes contain all information needed for fair presentation in accordance with U.S. GAAP. |
|  | Transaction related | |
|  | Segregation of duties:[[15]](#footnote-15) |  |
|  | 18. The entity is exposed to loss of assets and various potential misstatements, including certain of those above, as the result of inadequate segregation of duties. | 18. Persons do not have uncontrolled access to both assets and records; they are not assigned duties to put them in a position that would allow them to both commit and conceal errors or fraud. |

395 C – Typical Control Activities

Authorization

1. Authorization controls are designed to provide reasonable assurance that (1) transactions, (2) events from which they arise, and (3) procedures under which they are processed are authorized in accordance with laws, regulations, contracts, grant agreements, and management policy. Typical authorization controls include

* documented policies establishing events or transactions that the entity is authorized to engage in by law, regulation, contract, grant agreement, or management policy;
* documented policies and procedures exist for processing transactions in accordance with laws, regulations, contracts, grant agreements, or management policy; and
* master files that include only authorized employees, customers, or suppliers.

Approval

Approval controls are designed to provide reasonable assurance that appropriate individuals approve recorded transactions in accordance with management’s general or specific criteria. Typical approval controls occur when the following occurs:

* Transactions are approved by persons having the authority to do so (such as the specific approval of purchases by the procurement officer or other designated individual with procurement authority) in accordance with established policies and procedures.
* Transactions are compared with predetermined expectations (invoice terms are compared with agreed-upon prices, input is checked for valid data type for a particular field, etc.), and exceptions are reviewed by someone authorized to approve them.
* Transactions are compared with approved master files (such as approved customer credit limits or approved vendors) before approval or acceptance, and exceptions are reviewed by someone authorized to approve them or correct the situation.
* Key records are matched before a transaction is approved (such as the matching of purchase order, receiving report, and vendor invoice records before an invoice is approved for payment).
* Before acceptance, changes to data in existing files are independently approved, evidenced by either documentary or online approval of input before processing.

Segregation of Duties

Segregation-of-duties controls are designed to reduce the opportunities for someone to both cause and conceal errors or fraud. Typically, an entity achieves adequate segregation of duties by establishing controls (such as segregating asset custody from recordkeeping functions) to prevent any person from having uncontrolled access to both assets and records. See FAM 330.08 and 360.13 through .14 for additional discussions of segregation-of-duties controls.

Design and Use of Documents and Records

Controls over the design and use of records help provide reasonable assurance that transactions and events are recorded. Such controls typically include the following:

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

Safeguards over Access to and Use of Assets and Records

1. Access controls are designed to protect assets and records against physical harm, theft, loss, misuse, or unauthorized alteration. These controls restrict **unauthorized** access to assets and records. The auditor should determine whether to evaluate segregation of duties of persons who have **authorized** access to assets and records based on FAM 330.08. Typical access controls include the following:

* Cash receipt totals are recorded before cash is deposited.
* Secured facilities (locked rooms, fenced areas, vaults, etc.) are used. Access to critical forms and equipment (such as check signing machines and signature stamps) is limited to authorized personnel.
* Access to information system programs and data files is restricted to authorized personnel. (For example, manual records, computer terminals, and backup files are kept in secured areas to which only authorized persons can gain access. Access is restricted by logical access controls.)
* Assets and records are protected against physical harm. (For example, intruder alarms, security guards, fire walls, a sprinkler system, etc., are used to prevent intentional or accidental destruction of assets and records.)
* Incoming and outgoing assets are counted, inspected, and received or disposed/transferred/sold only on the basis of proper authorization (such as a purchase order, contract, or shipping order) in accordance with established procedures.
* Procedures provide reasonable assurance that current files can be recovered in the event of a computer failure. (For example, the entity has implemented a backup and recovery plan, such as using on-premises or off-premises file backup, off-site storage of duplicate programs and operating procedures, and standby arrangements to use a second processing facility if the entire data center is destroyed.)
* Access to critical forms and records is restricted. (For example, secured conditions are established and maintained for manual records and media used to access assets, such as blank checks or forms for the release of inventory.)

Independent Checks

Controls are designed to provide independent checks of the validity, accuracy, and completeness of processed data. Procedures that are typical of this category of controls include the following:

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

Valuation Controls of Recorded Amounts

Controls in this category are designed to provide reasonable assurance that assets are accurately valued at appropriate amounts. Typical valuation controls are as follows:

* Periodic evaluation of the condition and marketability of assets. (For example, inventory is periodically reviewed for physical damage, deterioration, or obsolescence, or receivables are evaluated for collectability.)
* Recorded data are compared with information from an independent third party. (For example, recorded cash is reconciled to bank statements, and suppliers’ accounts are reconciled to monthly statements from suppliers.)
* Assessed values (such as independent appraisals of assets) are compared with the accounting records.

Summarization of Accounting Data

Controls in this category are designed to provide reasonable assurance that transactions are accurately summarized and that any adjustments are valid. Typical controls in this category include the following:

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

Rights and Obligations Controls

Controls in this category are designed to provide reasonable assurance that (1) the entity owns recorded assets, with the ownership supported by appropriate documentation; (2) the entity has the rights to its assets at a given date; and (3) recorded liabilities reflect the entity’s obligations at a given date. Procedures that are typical of this category of controls include the following:

* Policies and procedures are documented (such as policy, procedures, and training manuals, together with organization charts) for initiating transactions and for identifying and monitoring those transactions and accounts warranting attention with respect to ownership.
* Policies and procedures are documented for initiating and monitoring transactions and accounts related to obligations.
* Significant transactions require the approval of senior management.
* Reported results and balances are compared with plans and authorizations.

Presentation and Disclosure Controls

Controls in this category are designed to provide reasonable assurance that (1) accounts are properly classified and described in the financial statements, (2) the financial statements are prepared in conformance with U.S. GAAP, and (3) footnotes contain all information needed for fair presentation. Procedures that are typical of this category of controls include the following:

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

395 D – Selected Statutes Relevant to Budget Execution

1. **Antideficiency Act:** This statute places limitations on the obligation and expenditure of government funds. Expenditures and obligations may not exceed the amounts available in the related appropriation or fund accounts. Unless expressly allowed by law, amounts may not be obligated before they are appropriated. Additionally, the amount of obligations and expenditures may not exceed the amount of the apportionments received. (See 31 U.S.C. sections 1341-1342, 1351, and 1517 for further information.) Also, see FAM 803.
2. **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.)
3. **Time statute:** This statute states that appropriations may be obligated or expended only during the period of availability specified by law. (See 31 U.S.C. 1502 for further information.)

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

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

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

395 E – Budget Execution Process

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

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

1. The design of the budget execution process is of interest to the auditor when testing the statement of budgetary resources and reconciliation of net cost of operations to budget note disclosure and when evaluating an entity’s internal control relating to budget execution.[[16]](#footnote-16)

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

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

* OMB makes an **apportionment**, which is a distribution of amounts available for obligation. Apportionments divide amounts available for obligation by specific periods (usually quarters), activities, projects, objects, or a combination thereof. The amounts apportioned limit the amount of obligations that may be incurred.
* The entity head (or other authorized employee) makes an **allotment**, which is an authorization to subordinates to incur obligations within a specified amount. The total amount allotted by an entity may not exceed the amount apportioned by OMB. The entity, through its fund control regulations, establishes allotments at a legally binding level for complying with the Antideficiency Act. Suballotments and allowances are further administrative divisions of funds, usually at a more detailed level (i.e., suballotments are divisions of allotments established as needed).
* The entity may make a **commitment**, which is an administrative reservation of an allotment or of other funds in anticipation of their obligation. Commitments are not required by law or regulation nor are they formal/official uses of budget authority. Rather, entities use commitments for financial planning in the acquisition of goods and services and control over obligations and the use of budget authority.
* The entity incurs an **obligation**,[[17]](#footnote-17) which is the amount of purchase orders placed, contracts awarded, services received, and similar transactions during a given period that will require payments during the same or future periods. The entity should comply with legal requirements before recording obligations against appropriation accounts (title 7 of the *GAO Policies and Procedures Manual*). These legal requirements include determining whether the purpose, the amount, and the timing of when the obligation was incurred are in accordance with the appropriation. Additionally, there are legal requirements concerning the documentary evidence necessary for recording an obligation. The term **obligation** in this manual refers to orders for goods and services that have not been delivered (undelivered orders).

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

* The entity records **expended authority**, which is the reduction of an obligation by the receipt and acceptance of goods and services ordered. Expended authority means that the budget authority has been used to acquire goods or services.[[18]](#footnote-18)
* The entity records an **outlay**, which, as used in the President’s budget, congressional budget documents, and the statement of budgetary resources, refers to payments (cash disbursements) made to liquidate obligations for goods and services. The statement of budgetary resources reconciles obligations incurred net of offsetting collections to net outlays.
* The appropriation account **expires** when, according to the restrictions contained in the appropriation, the appropriation is no longer available for new obligations. For annual appropriations, this occurs at midnight on September 30.[[19]](#footnote-19) Adjustments may be made for valid obligations that were either (1) recorded at an estimated amount that differs from the actual amount[[20]](#footnote-20) or (2) incurred before the authority expired but not recorded. Adjustments may be recorded for 5 years after the appropriation expires. For both expired accounts and closed accounts, the entity’s obligations and expenditures may not exceed the related budget authority. See OMB Circular No. A-11, part 4, for additional guidance on these types of adjustments and transactions.

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

* canceled orders or orders for which delivery is no longer likely,
* refunds received in the current period that relate to recovery of erroneous payments or accounting errors,
* legal and valid obligations that were previously unrecorded, and
* differences between the estimated and actual obligation amounts.
* After the 5-year period, the budget authority for the expired accounts is **canceled** and the expired accounts are **closed**.[[21]](#footnote-21) 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. See OMB Circular No. A-11, part 4, for additional guidance on these types of adjustments and transactions.

395 F – Budget Control Objectives

1. This section lists budget control objectives by steps in the budget process. The auditor may use these control objectives for either or both of the audit of the statement of budgetary resources and the reconciliation of net cost of operations to budget note disclosure, the evaluation of financial reporting controls; and/or as part of the evaluation of the design of compliance controls. The auditor may evaluate the design of many of these controls at the same time as evaluating the design of controls over expenses, disbursements, and liabilities. When testing control effectiveness, the auditor may test these controls at the same time, which is referred to as multipurpose testing.
2. **Appropriations (or other forms of budget authority):** The recorded appropriation (or other form of budget authority) is the same as that made available in the appropriation or other appropriate statutes, including restrictions on amount, purpose, and timing.
3. **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.[[22]](#footnote-22)
4. **Allotments/suballotments:** The total amount allotted does not exceed the total amount apportioned.
5. **Commitments:** The auditor may not be concerned with controls over budgetary commitments because commitments are not required by law or regulation nor are they formal/official uses of budget authority. Controls over budgetary commitments are a type of operations control.

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

1. **Obligation transactions:** The control objectives relating to obligation transactions (undelivered orders) are as follows:

* **Validity/occurrence:** Obligations recorded are valid. An obligation is valid only if it meets these criteria:
  + The obligation has been incurred. This is usually evidenced by appropriate supporting documentation, such as a purchase order or contract.
  + The auditor may look for instances of “block obligating” or “block dumping,” which occur when an entity records obligations to “reserve” funds even though the goods or services have not been ordered. This is most likely to occur near the expiration of an appropriation and usually occurs in large dollar services and equipment contracts. The auditor may look for such signs as large, even-amount obligations near the end of the fiscal year for annual appropriations or during the last year of a multiyear appropriation account.
  + The purpose of the obligation is one for which the appropriation was made.
  + The obligation was incurred within the time that the appropriation was made available for new obligations.
  + The obligation did not exceed the amount allotted or appropriated by statute nor was it incurred before the appropriation became law, unless otherwise provided by law.
  + The obligation complies with any other legally binding restrictions, such as obligation ceilings or earmarks, identified in the planning phase.
  + The obligation has not subsequently been canceled nor have the goods or services been received.
  + For adjustments to obligations in expired accounts, objectives are as follows:
    1. If the adjustment represents a “contract change,” as defined in OMB Circular No. A-11, refer to the entity’s reporting and approval requirements in that circular.
    2. The adjustment does not cause the entity to exceed the amount allotted or appropriated by statute.
    3. 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.
    4. New obligations are not to be recorded in expired accounts.
* **Completeness:** All obligation transactions are recorded.
* **Valuation/accuracy:** Obligations are recorded at the best available estimate of actual cost.
* **Cutoff:** Obligations are recorded in the proper period.
* **Classification:** Obligations are recorded in the proper appropriation or fund accounts (also by program and by object, if applicable), including the proper appropriation year if the account is multiyear. Examples of programmatic account classifications are: school lunch program and nutrition education and training. Examples of object account classifications are: salaries, rent, and travel.

1. **Expended authority transactions:** Control objectives relating to expended authority transactions, as defined in FAM 395 E, are generally the same as those for obligation transactions.

* **Validity/occurrence:** For all expended authority transactions, recorded expended authority transactions have occurred. This occurrence is usually evidenced by appropriate supporting documentation, such as invoices and receiving reports. Accrual of liabilities based on incurred but unbilled contractor costs alone is not sufficient evidence of validity (i.e., it may not meet the purpose, time, and amount provisions of an appropriation). For expended authority transactions (or adjustments to expended authority transactions) in expired accounts, the entity objectives are that
  + the expended authority transaction does not cause the entity to exceed the amount appropriated by statute,
  + the expended authority transaction is recorded during the period when the account is available for adjustments (5 years), and
  + the expenditure is not made out of a closed account.
* **Completeness:** All expended authority transactions and adjustments are recorded.
* **Valuation/accuracy:** Expended authority transactions and adjustments are recorded at the correct amount.
* **Cutoff:** Expended authority transactions and adjustments are recorded in the proper period.
* **Classification:** Expended authority transactions and adjustments are recorded in the proper appropriation or fund accounts (also by program and by object, if applicable), including the proper appropriation year if the account is multiyear.

1. **Outlay transactions:** Control objectives that relate to outlay transactions and may be tested while auditing cash disbursements are as follows:

* **Validity/occurrence:** Outlays are supported by evidence such as contractor invoices, receiving reports, and intra-governmental payment and collection (IPAC) reports. The outlay is recorded against an obligation made during the period of availability of the appropriation (not made out of a closed account). The outlay is also for a purpose for which the appropriation was provided and in an amount not exceeding the obligation, as adjusted, authorizing the outlay. Use of “first-in, first-out” or other arbitrary means to liquidate obligations based on outlays is not generally acceptable unless supporting evidence demonstrates that in fact these estimating techniques reasonably represent the manner in which costs are incurred. (Note: Internal control over outlays and related liquidation of obligations may provide safeguards against improper payments, such as erroneous, duplicative, or fraudulent contractor billings.)
* **Completeness:** All outlays and adjustments are recorded.
* **Valuation/accuracy:** Outlays and adjustments are recorded at the correct amounts.
* **Classification:** Outlays are recorded in the proper accounts (both by program and by object, if applicable), including the proper appropriation year if the account is multiyear. This is evidenced by “matching” the outlay to the underlying obligation.
* **Cutoff:** Outlays and adjustments are recorded in the proper period.

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

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

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

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

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

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

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

1. **Outlay account balances:** Control objectives relating to outlay account balances appearing in the statement of budgetary resources for the fiscal year are as follows:

* **Summarization:** Recorded balances of outlay accounts for the fiscal year are supported by appropriate detailed records that are accurately summarized for each account.
* **Substantiation:** Recorded account balances are supported by valid outlay transactions.

1. **Recording of cash receipts related to closed appropriation accounts:** This control is to be evaluated only if these amounts are expected to exceed performance materiality. The control objective is as follows:

* **Compliance:** Collections authorized or required to be credited to an appropriation account but not received before the account is closed are deposited in the Treasury as miscellaneous receipts (31 U.S.C. 1552(b)).

Budget Control Objectives under the Federal Credit Reform Act

1. The Federal Credit Reform Act (FCRA) contains provisions regarding the recording and reporting of activity related to direct loans, loan guarantees, and modifications of these items for budget accounting purposes. Definitions of these and other FCRA terms are provided in paragraph .03 below. For transactions and account balances related to these types of activities, the auditor generally should use the budget control objectives listed in FAM 395 F and supplement them with the following budget control objectives related to FCRA. Additional guidance on FCRA accounting for budget purposes is included in OMB Circular No. A-11. Also, see Federal Financial Accounting and Auditing Technical Releases No. 3, *Auditing Estimates for Direct Loan and Loan Guarantee Subsidies Under the Federal Credit Reform Act* (as amended), and No. 6, *Preparing Estimates for Direct Loan and Loan Guarantee Subsidies Under the Federal Credit Reform Act*.
2. **Obligation transactions:** Obligation transactions include direct loan obligations, loan guarantee commitments, and modifications that change the cost of an outstanding direct loan or loan guarantee (modifications do not include changes to outstanding direct loans or loan guarantees that are within the terms of existing contracts or through other existing authorities). The supplemental control objective relating to obligation transactions under FCRA is as follows:

* **Valuation:** When funds are obligated for a direct loan or loan guarantee, the estimated cost shall be based on the “current” assumptions, adjusted to incorporate the terms of the loan contract, for the fiscal year in which the funds are obligated.[[23]](#footnote-23)
  + - 1. The cost of a direct loan is recorded at the net present value, at the time when the loan is disbursed, of estimated cash flows for
         1. loan disbursements;
         2. principal repayments;
         3. interest payments; and
         4. other payments by or to the government over the life of the loan, including fees, penalties, and other recoveries, as well as adjustments for estimated prepayments, delinquencies, and defaults.

These estimated cash flows include the effects of the timing and are discounted using the appropriate rate as described below. Administrative costs and any incidental effects on governmental receipts and outlays are not included in the cost of the direct loan (2 U.S.C. 661a(5)(A) and (B)).

* + - 1. The cost of a loan guarantee is recorded at the net present value, at the time when the related guaranteed loan is disbursed, of the cash flows for
         1. estimated amounts and timing of payments by the government for defaults, delinquencies, interest subsidies, or other payments, excluding administrative costs, and
         2. estimated amounts and timing of payments to the government for origination and other fees, penalties, and recoveries.

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

* + - 1. The cost of a modification is recorded at the difference between the current estimated net present value of the remaining cash flows under the existing direct loan or guarantee contract and the estimated net present value of the remaining cash flows under the modified contract. The cash flows for each of these calculations are discounted at the rate for modifications described below (2 U.S.C. 661a(5)(D)).
      2. The discount rate used to estimate the net present values described above is the average interest rate on marketable Treasury securities of similar maturity to the cash flows of the direct loan or loan guarantee for which the estimate is being made (2 U.S.C. 661a(5)(E)).

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

* **Valuation:** Expended authority transactions are recorded at the proper amount. The same specific criteria for the amounts of FCRA obligations are also applicable to expended authority transactions.
* **Cutoff:** Expended authority transactions are recorded in the proper period. Expended authority transactions for the cost of loans or guarantees are recorded in the fiscal year in which the direct or guaranteed loan is disbursed or when a modification occurs (2 U.S.C. 661c(d)(2)).
* **Classification/presentation and disclosure:** Amounts are recorded in the proper account and reported appropriately for:
  + Differences in subsequent years between original estimated costs and reestimated costs are recorded in a separately identified subaccount in the credit program account and shown as a change in program costs and a change in net interest (2 U.S.C. 661c(f)).
  + Funding for the administrative costs of a direct loan or loan guarantee program is recorded in separately identified subaccounts within the same budget account as the program’s cost (2 U.S.C. 661c(g)).
  + Cash disbursements for direct loan obligations or loan guarantee commitments made on or after October 1, 1991, are made out of the financing account (2 U.S.C. 661a(7)).

1. **Obligation and expended authority balances:** The supplemental control objective relating to obligation and expended authority balances under FCRA as of a point in time is:

* **Limitation:** Total obligations and total expended authority transactions do not exceed the appropriation amount or other statutory limitations that may exist by appropriation period. Specifically, see the following:
  + Direct loan obligations made on or after October 1, 1991, do not exceed the available appropriation or other budget authority.
  + Modifications made to direct loan obligations or direct loans do not exceed the available appropriation or other budget authority. (Note: Prior to performing any control or compliance tests, the auditor should discuss with OGC the applicability of this budget restriction to direct loans and direct loan obligations that were outstanding prior to October 1, 1991.)
  + Obligations for new loan guarantee commitments made on or after October 1, 1991, do not exceed the available appropriation or other budget authority.
  + Modifications made to loan guarantee commitments or outstanding loan guarantees do not exceed the available appropriation or other budget authority. (Note: Prior to performing any control or compliance tests, the auditor should discuss with OGC the applicability of this budget restriction to loan guarantees or loan guarantee commitments that existed prior to October 1, 1991.)

1. **Cash receipts:** The control objective for cash receipts under FCRA is as follows:

* **Classification:** Cash receipts are recorded in the proper account for:
  + Cash receipts related to direct loans obligated or loan guarantees committed prior to October 1, 1991, are recorded in the liquidating accounts (2 U.S.C. 661f(b)).
  + Cash receipts related to direct loan obligated or loan guarantees committed on or after October 1, 1991, are recorded in the financing account (2 U.S.C. 661a(7)).

Definitions used in FCRA are:

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

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

395 G – Specific Control Evaluation Worksheet

1. The auditor should use the SCE worksheet or equivalent to document the evaluation of the design and implementation of the control activities in the internal control phase and the results of testing in the testing phase. This section illustrates an SCE worksheet for the **cash receipts** accounting application for a hypothetical federal government entity, “XYZ Entity” (XYZ).

The auditor should prepare an SCE worksheet or equivalent for each significant accounting application. The auditor generally should use the SCE worksheet to document the evaluation of compliance (including budget) and operations controls. The worksheet may be completed for financial reporting controls as follows:

* In column 1, list each assertion that is relevant to the accounting application. While all five financial statement assertions described in FAM 235 relate to line item/account-related accounting applications, the existence or occurrence, completeness, and accuracy/valuation assertions relate principally to transaction-related accounting applications, as illustrated in FAM 395 B. Therefore, assertions relevant to cash receipts would be existence or occurrence, completeness, and accuracy/valuation.
* In columns 2 and 3, list the significant line items or accounts that the accounting application affects, which is obtained from the LIRA (see FAM 240). For example, cash receipts typically affect cash and accounts receivable. Document the assertions (see FAM 330) for each line item or account identified that relate to each accounting application assertion.
* In columns 4 and 5, respectively, for each significant account assertion, identify the potential misstatements (inherent risks) that could occur in the accounting application and the related control objectives, based primarily on the list of potential misstatements and control objectives included in FAM 395 B. The auditor may tailor this list to the accounting application and the entity. In addition, the auditor may add additional objectives or subobjectives.[[24]](#footnote-24)
* In column 6, list control activities selected for testing that achieve each control objective identified. FAM 395 C illustrates typical control activities to achieve financial reporting control objectives.
* In column 7, indicate whether each control activity is an IS control, a manual control, or both an IS control and a manual control. Due to the technical nature of many IS controls, the auditor generally should obtain assistance from an IS controls auditor in understanding the entity’s use of information systems and in planning, directing, or performing audit procedures related to assessing IS controls. Additionally, an information technology specialist may assist the auditor in understanding technical aspects of information systems and IS controls. As noted in FAM 350.11, the auditor generally should obtain concurrence from an IS controls auditor on the auditor’s identification of IS controls. IS controls consist of those internal controls that are dependent on information system processing and include general controls, application controls, and user controls. A user control can be an IS control or a manual control. User controls are considered IS controls if a dependency on information system processing exists. A user control that is an IS control is identified as both an IS control and a manual control on the SCE worksheet. Conversely, user controls are considered manual controls if no dependency on information system processing exists. A user control that is a manual control is identified as a manual control on the SCE worksheet. Manual controls are not dependent on information system processing—either in the performance of the control activity or in the production of information used in the performance of the control activity. See FAM 295 F for additional information on the types of IS controls.
* In column 8, based on procedures performed in the internal control phase, conclude as to whether the control activity is designed and implemented effectively. Additionally, as noted in FAM 360.03, the auditor should also identify other IS controls (application controls and general controls implemented at the entitywide, system, and application levels) upon which the effectiveness of the IS controls included on the SCE worksheet depends. IS controls auditors will often need to assist the auditor in assessing the design and implementation of controls designated as IS controls on the SCE worksheet. As part of this assessment, the auditor assesses the design and implementation of other IS controls upon which the effectiveness of the IS controls included on the SCE worksheet depends.
* In column 9, reference the audit documentation supporting the conclusion on whether the control activity is designed and implemented effectively.
* In column 10, based on the results of the testing phase audit procedures, enter a conclusion regarding the operating effectiveness of each control activity. IS controls auditors will often need to assist the auditor in assessing the operating effectiveness of controls designated as IS controls on the SCE worksheet. As part of this assessment, the auditor assesses the operating effectiveness of other IS controls upon which the effectiveness of the IS controls included on the SCE worksheet depends.
* In column 11, conclude on whether each control objective has been achieved. This conclusion will need to consider the impact of mixed results on the effectiveness of listed individual control activities for achieving a control objective (e.g., one of the four control activities for achieving a control objective may have been ineffective, however; the combination of all control activities achieved the control objective).
* In column 12, reference the audit procedures in the detailed control testing audit plan that were designed to test each effective control determined to be relevant.

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

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

| ACCOUNTING APPLICATION: CASH RECEIPTS | | | | | | | | | | | |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| ACCOUNTINGAPPLICATIONASSERTION | RELEVANT ASSERTIONS IN RELATED GROUPS OF ACCOUNTS[[25]](#footnote-25) | | POTENTIAL MISSTATEMENT IN ACCOUNTING APPLICATION ASSERTIONS | INTERNAL CONTROL OBJECTIVES (ICO) | INTERNAL CONTROL ACTIVITIES (ICA) | Type of ICA:  IS,  B(oth) IS and Manual, or  M(anual) | INTERNAL CONTROL PHASE | | TESTING PHASE | | |
| Is the ICA Designed and Implemented Effectively? | Audit Doc. Ref.[[26]](#footnote-26) | Is the ICA Operating Effectively? | Is the ICO Achieved? | Audit Plan Testing Step[[27]](#footnote-27) |
| Cash | Accts. Rec. |
| (1) | (2) | (3) | (4) | (5) | (6) | (7) | (8) | (9) | (10) | (11) | (12) |
| Existence or occurrence | Existence or occurrence | Completeness | Occurrence/validity: |  |  |  |  |  |  |  |  |
| 1. Receipt is recorded, but cash is not received. | 1a. Recorded cash receipts and cash receipt processing procedures are authorized by federal laws, regulations, and management’s policy. | 1a. Receipts processing is governed by documented procedures for accepting, obtaining, reviewing, and approving receipts. | M | Y |  | Y | Y |  |
| 1b. Appropriate individuals approve recorded receipts in accordance with management’s general or specific criteria. | 1b. A supervisor reviews receipts processing to provide reasonable assurance that procedures are followed. | M | Y |  | Y | Y |  |
| 1c. Recorded receipts represent amounts actually received by the entity and are properly classified. | 1c1. Recorded cash receipts are matched with the appropriate supporting documentation. | M | Y |  | Y | Y |  |
| 1c2. Entries to the accounting records are reviewed and approved by supervisory personnel. | M | Y |  | N |  |
| Cutoff: |  |  |  |  |  |  |  |  |
| 2. Receipts are recorded in this period, but the cash is received in a different period. | 2. Cash receipts recorded in the period are actually received in the period. | 2. Entity personnel reconcile recorded receipts to cash receipts listings and bank deposit reports before posting. | B | Y |  | Y | Y |  |
| Summarization: |  |  |  |  |  |  |  |  |
| 3. Receipt transactions are overstated due to improper summarization. | 3. The summarization of receipt transactions is not overstated. | 3a. Entity personnel reconcile receipt data in the general ledger to subsidiary cash ledgers and records. | B | Y |  | Y | Y |  |
| 3b. Batch totals of input documents are automatically reconciled to output registers, journals, reports, or file updates. | B | Y |  | Y |  |
| Completeness | Completeness | Existence or occurrence | Transaction completeness: |  |  |  |  |  |  |  |  |
| 4. Cash is received, but receipt is not recorded. | 4. All receipts of cash are recorded and properly classified. | 4a. Cash receipts are listed by the central mailroom staff and independently reconciled to deposits and accounting summaries, providing adequate segregation of duties. Collections and complaints are handled by others. | M | Y |  | Y | Y |  |
| 4b. Supervisory reviews of the processing of cash receipts. | M | Y |  | Y |  |
| Cutoff: |  |  |  |  |  |  |  |  |
| 5. Cash is received in this period, but receipt is recorded in a different period. | 5. Cash receipts actually received in the period are recorded in the period. | 5. Same as procedure 2 above. | B | Y |  | Y | Y |  |
| Summarization: |  |  |  |  |  |  |  |  |
| 6. Receipt transactions are understated as a result of improper summarization. | 6. The summarization of cash receipt transactions is not understated. | 6. Same as procedures 3a and 3b above. | B | Y |  | Y | Y |  |
| Accuracy/ valuation | Valuation | Valuation | Accuracy: |  |  |  |  |  |  |  |  |
| 7. Receipt transactions are recorded at incorrect amounts. | 7. Receipt transactions are recorded accurately. | 7a. Recorded receipts are compared with bank statements by persons who have no other receipts processing responsibilities. | M | Y |  | Y | Y |  |
| 7b. Supervisor reviews and approves reconciliations of recorded receipts to bank statements. | M | Y |  | Y |  |
|  |  |  |  | Segregation of duties:[[28]](#footnote-28) | |  |  |  |  |  |  |
| 8. Persons are prevented from having uncontrolled access to both cash receipts and records. | 8a. Management reviews roles and responsibilities to ensure no individual has uncontrolled access (direct or indirect) to both cash receipts and records. | M | Y |  | Y | Y |  |
|  |  |  |  | Laws, regulations, contracts, and grant agreements:[[29]](#footnote-29) | |  |  |  |  |  |  |
| 9. [Based on the description of the provision, document the control objective.] |  | M | Y |  | Y | Y |  |

395 H – Line Item Risk Analysis Form

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

Planning Phase:

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

Internal Control Phase:

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

Testing Phase:

* In column 12, identify the timing of audit procedures performed as either interim (I) or final (F) (see FAM 420 and FAM 430).
* In column 13, briefly describe the nature and extent of audit procedures performed (see FAM 420 and FAM 430).
* In column 14, provide a reference to the audit procedure step number(s) in the testing audit plan.

1. If the results of testing indicate that the preliminary assessment of the risk of material misstatement was not appropriate, the auditor should document the revised assessment in the LIRA form and provide a summary of the factors contributing to the revised assessment in a memorandum, as appropriate.
2. The auditor may also document insignificant line items and accounts in the LIRA form rather than in the cycle matrix. Regardless, the auditor should document that **all** accounts have been considered in the audit.

| ENTITY: *XYZ Entity (XYZ)*  DATE OF FINANCIAL STATEMENTS: *9/30/xx*  LINE ITEM: *Accounts Receivable - Net* | **LINE ITEM RISK ANALYSIS FORM**  **INDEX: \_\_\_\_\_\_\_\_\_\_\_\_\_** | PREPARER \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_  REVIEWER \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_  DATE \_\_\_\_\_\_\_\_\_\_\_\_ |
| --- | --- | --- |

| PLANNING PHASE | | | | | | | | INTERNAL CONTROL PHASE | | | TESTING PHASE | | |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Line Item | | Financial Statement Assertions | Inherent Risk Factors | Fraud Risk Factors | Control Risk Factors | Mitigating Factors | Cycle/ Accounting Application | Effectiveness of Control Activities | Control Risk | Risk of Material Misstatement | Timing I/F | Nature & Extent | Audit Plan Testing Step |
| Name | Balance |
| (1) | (2) | (3) | (4) | (5) | (6) | (7) | (8) | (9) | (10) | (11) | (12) | (13) | (14) |
| Accounts Receivable-Net | $876,000,000 | Existence or occurrence | No significant inherent risk factors identified. | No significant fraud risk factors identified. | No significant control risk factors identified. | No mitigating factors identified. | Sales/ billing | Effective | Low | Low | F | Confirm balances and test reconciliation of subsidiary ledger to the general ledger. | AR Testing Plan – III‑5 to III‑7 |
| Sales returns | Effective |
| Cash receipts | Effective |
| Accounts receivable | Effective |
| Completeness | No significant inherent risk factors identified. | No significant fraud risk factors identified. | No significant control risk factors identified. | No mitigating factors identified. | Sales/ billing | Effective | Low | Low | F | Perform analytical procedures. Test cutoff. | AR Testing Plan – III‑8 to III‑12 |
| Sales returns | Effective |
| Cash receipts | Effective |
| Accounts receivable | Effective |
| Accuracy/ valuation | The bankruptcy filing by a major debtor and the financial difficulties of several other debtors in the current economic environment give rise to an inherent risk. | No significant fraud risk factors identified. | No significant control risk factors identified. | No mitigating factors identified. | Sales/ billing | Effective | Low | Moderate | F | Confirm balances (see Existence), test the accuracy of the aging, analytically review bad debts and allowance, and examine evidence of collectability for selected accounts receivable. Discuss with management collectability from troubled debtors. | AR Testing Plan – III‑13 to III-18 |
| Sales return | Effective |
| Cash receipts | Effective |
| Accounts receivable | Effective |
| Rights and obligations | No significant inherent risk factors identified. | No significant fraud risk factors identified. | No significant control risk factors identified. | No mitigating factors identified. | Accounts receivable | Effective | Low | Low | F | Identify accounts receivable from related parties or major debtors. Review confirmations for indication of guarantees or encumbrances. | AR Testing Plan – III‑19 to III-22 |
| Presentation and disclosure | No significant inherent risk factors identified. | No significant fraud risk factors identified. | No significant control risk factors identified. | No mitigating factors identified. | Accounts receivable | Effective | Low | Low | F | Determine appropriateness of footnote disclosures using FAM 2010 and FAM 2020 checklists. Summarize and test credit risk disclosures. Review accounting principles used. | AR Testing Plan – III‑23 to III-25, IV‑16 |
| Line Item Total | $876,000,000 | | | | | | | | | | | | |

1. In this section, the term “auditor” is referring to the “user auditor” and the term “entity” is referring to “user entity” as defined in AU-C 402. [↑](#footnote-ref-1)
2. Report on the fairness of the presentation of management’s description of the service organization’s system and the suitability of the design of the controls to achieve the related control objectives included in the description as of a specified date. [↑](#footnote-ref-2)
3. Report on the fairness of the presentation of management’s description of the service organization’s system and the suitability of the design and operating effectiveness of the controls to achieve the related control objectives included in the description throughout a specified period. [↑](#footnote-ref-3)
4. The auditor generally should coordinate sampling control tests with substantive audit procedures and/or tests of compliance with applicable laws, regulations, contracts, and grant agreements (multipurpose tests) to maximize efficiency. See FAM 450 for further discussion. [↑](#footnote-ref-4)
5. As indicated in FAM 260.65 through .70, the Federal Managers’ Financial Integrity Act report and its supporting documentation may be used as a starting point for understanding and evaluating internal control. The auditor may use management’s documentation of systems and internal control, including A-123 work, where appropriate. The auditor may use management’s tests of controls as part of the auditor’s tests of controls, if such tests were executed by competent individuals independent of the controls. (See FAM 640 and FAM 645 for further information.) [↑](#footnote-ref-5)
6. FAM 395 C presents a list of typical control activities that an entity may establish to help prevent or detect and correct misstatements in financial statement assertions. [↑](#footnote-ref-6)
7. Assertions that have high inherent risk normally require stronger or more extensive controls to prevent, or detect and correct, misstatements than assertions without such risk. [↑](#footnote-ref-7)
8. Control environment, risk assessment, communication, and monitoring weaknesses may result in ineffective control activities. If so, the auditor should still understand the design of specific control activities and determine whether they have been implemented, as discussed in FAM 340.02. [↑](#footnote-ref-8)
9. FMFIA report on conformance with federal financial management system requirements. *See* 31 U.S.C. § 3512(d)(2). [↑](#footnote-ref-9)
10. Refer to the FISCAM for further information. [↑](#footnote-ref-10)
11. Refer to the FISCAM for further information. [↑](#footnote-ref-11)
12. The auditor may assess the risk of material misstatement on a preliminary basis at an earlier point in the audit, if preferred. This may be particularly appropriate for a recurring audit where the auditor has an understanding of the design of the control environment, entity risk assessment, information and communication, and monitoring components of internal control. [↑](#footnote-ref-12)
13. Specific relevant control activities for significant assertions are documented later in the SCE worksheet or equivalent, after related control objectives have been identified (see FAM 330.02 through .11). [↑](#footnote-ref-13)
14. Based on inherent risk, the auditor may choose to add an additional potential misstatement and control objective regarding the overstatement of disclosure information. The potential misstatement may be worded as “Information disclosed in the financial statements did not occur or does not pertain to the rights and obligations of the entity.” The control objective may be worded as “All information disclosed in the financial statements actually occurred and pertains to the rights and obligations of the entity.” [↑](#footnote-ref-14)
15. Segregation-of-duties controls are a type of safeguarding control and are often crucial to the effectiveness of controls, particularly over liquid, readily marketable assets that are highly susceptible to theft, loss, or misappropriation. Such controls are designed to reduce the opportunities for any person to be in a position to both commit and conceal fraud. The lack of segregation-of-duties controls may be pervasive and affect several misstatements. *Financial Audit Manual* 330.08 discusses when the auditor should test segregation-of-duties controls. [↑](#footnote-ref-15)
16. For additional information on budget execution, see OMB Circular No. A-11, *Preparation, Submission, and Execution of the Budget,* part 4*.* Another useful document is GAO’s *A Glossary of Terms Used in the Federal Budget Process* (GAO-05-734SP, September 2005). The SGL and related accounting in the TFM can be found at <http://www.fms.treas.gov/index1.html>. [↑](#footnote-ref-16)
17. A definite commitment that creates a legal liability of the government for the payment of goods and services ordered or received, or a legal duty on the part of the U.S. that could mature into a legal liability by virtue of actions on the part of the other party beyond the control of the U.S. (GAO-05-734SP, September 2005) [↑](#footnote-ref-17)
18. In the normal flow of business, when obligations are incurred, a credit to “undelivered orders” or “unexpended obligations - unpaid” is recorded (SGL account 4801) with a debit to commitments (SGL account 4700 or 4720). When the goods or services are received, the obligation is debited (SGL account 4801) with a credit to “delivered orders-unpaid” or “expended authority - unpaid” (SGL account 4901). At this time, a proprietary accounting entry is also made to debit expenditures (usually an SGL account 6100) with a credit to accounts payable (SGL account 2110). When the obligation is paid and the outlay is made, the transaction is credited to “delivered orders - paid” or “expended authority - paid” (SGL account 4902). At this time, a proprietary accounting entry is also made to debit accounts payable (SGL account 2110) with a credit to FBWT (SGL account 1010). For additional transaction details, see TFM’s U.S. Standard General Ledger Accounting Transactions supplement. [↑](#footnote-ref-18)
19. Unobligated amounts are debited and moved to “allotments – expired authority” with a credit to SGL account 4650. [↑](#footnote-ref-19)
20. 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. [↑](#footnote-ref-20)
21. Expired authority (SGL account 4650) is debited and moved to “canceled authority” by a credit to SGL account 4350. At this time, a proprietary entry is made to debit and reduce “unexpended appropriations” (SGL account 3106) and to credit and reduce FBWT (SGL account 1010). [↑](#footnote-ref-21)
22. OMB apportionments may, as a result of impoundments (rescissions or deferrals), be less than the amount of the apportionments requested by the entity. The auditor generally should notify OGC of any impoundments that come to the auditor’s attention. OMB may also approve different amounts available than those requested by time period, activity, project, or object class. [↑](#footnote-ref-22)
23. The term current has the same meaning as in section 250(c)(9) of the Balanced Budget and Emergency Deficit Control Act of 1985. [↑](#footnote-ref-23)
24. On the SCE worksheet, the auditor may commingle the documentation of compliance (including budget) operations controls and safeguarding controls with that of financial reporting controls to the extent relevant, list this documentation separately in a section within the SCE worksheet, or present each of these types of controls in a separate SCE worksheet. To complete the SCE worksheet for these controls, the auditor begins by inserting relevant control objectives in column 5 and completing columns 6 through 12. [↑](#footnote-ref-24)
25. The third column is for use when the effects of the accounting application on the line items are different. For example, misstatements in the existence or occurrence assertion for cash receipts typically result in misstatements in the existence or occurrence assertion for cash and in the completeness assertion for accounts receivable (see Financial Audit Manual (FAM) 330.05). [↑](#footnote-ref-25)
26. In this column, the auditor references the audit documentation supporting the conclusion. [↑](#footnote-ref-26)
27. In this column, the auditor references the audit procedures in the detailed control testing audit plan (and information systems audit plan, as applicable) that were designed to test each effective control determined to be relevant. Such tests will involve inquiry, observation, inspection, or a combination thereof. [↑](#footnote-ref-27)
28. Segregation-of-duties controls are a type of safeguarding control and are often crucial to the effectiveness of controls, particularly over liquid, readily marketable assets that are highly susceptible to theft, loss, or misappropriation. If there is inadequate segregation of duties, the auditor should identify the specific affected account assertions in columns 2 and 3. [↑](#footnote-ref-28)
29. The auditor may commingle compliance controls (including budget) with financial reporting controls to the extent relevant, list them separately in this section, or present each of these types of controls in a separate SCE worksheet (see FAM 800 for examples of compliance SCE worksheets for laws and regulations). If the auditor chooses to list the compliance controls separately in this section, the auditor begins by inserting relevant control objectives and documents the effectiveness of the design and operation of the control activities in achieving the control objectives. [↑](#footnote-ref-29)