



# Financial Audit Manual

## Foreword

On behalf of the General Accounting Office (GAO) and the President's Council on Integrity and Efficiency (PCIE), we are pleased to present the first-ever *GAO/PCIE Financial Audit Manual*.

With passage of the Government Management and Reform Act of 1994, executive branch Inspectors General and GAO gained statutory responsibility for auditing agency and government-wide consolidated financial statements, respectively. Since that time, GAO and the PCIE community have worked cooperatively to ensure that these audits are of the highest possible quality, consistency, and cost-effectiveness. This manual is a natural outgrowth of that cooperation. More importantly, the new manual represents our ongoing efforts to ensure that financial statement audits achieve their intended outcomes of providing enhanced accountability over taxpayer-provided resources.

We extend our thanks to the many individuals and organizations that provided comments and insights to make the manual stronger. The Task Force assembled by GAO and the PCIE also deserves much credit for its dedication to completing this project.

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Managing Director  
U.S. General Accounting Office

The Honorable Gregory H. Friedman  
Chair, Audit Committee  
President's Council on Integrity  
and Efficiency

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# CONTENTS

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# CONTENTS

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<b>100</b>	<b>INTRODUCTION</b>
<b>200</b>	<b>PLANNING PHASE</b>
210	Overview
220	Understand the Entity's Operations
225	Perform Preliminary Analytical Procedures
230	Determine Planning, Design, and Test Materiality
235	Identify Significant Line Items, Accounts, Assertions, and RSSI
240	Identify Significant Cycles, Accounting Applications, and Financial Management Systems
245	Identify Significant Provisions of Laws and Regulations
250	Identify Relevant Budget Restrictions
260	Identify Risk Factors
270	Determine Likelihood of Effective Information System Controls
275	Identify Relevant Operations Controls to Evaluate and Test
280	Plan Other Audit Procedures <ul style="list-style-type: none"><li>• Inquiries of Attorneys</li><li>• Management Representations</li><li>• Related Party Transactions</li><li>• Sensitive Payments</li><li>• Reaching an Understanding with Management and Requesters</li><li>• Other Audit Requirements</li></ul>
285	Plan Locations to Visit
290	Documentation
	<b>Appendixes to Section 200:</b>
295 A	Potential Inherent Risk Conditions
295 B	Potential Control Environment, Risk Assessment, Communication, and Monitoring Weaknesses
295 C	An Approach for Multiple-Location Audits
295 D	Interim Substantive Testing of Balance Sheet Accounts
295 E	Effect of Risk on Extent of Audit Procedures
295 F	Types of Information System Controls
295 G	Budget Controls
295 H	Laws Identified in OMB Audit Guidance and Other General Laws
295 I	Examples of Auditor Responses to Fraud Risk Factors
295 J	Steps in Assessing Information System Controls

---

## Contents

---

### **300 INTERNAL CONTROL PHASE**

- 310 Overview
  - 320 Understand Information Systems
  - 330 Identify Control Objectives
  - 340 Identify and Understand Relevant Control Activities
  - 350 Determine the Nature, Timing, and Extent of Control Tests and of  
Tests for Systems' Compliance with FFMIA Requirements
  - 360 Perform Nonsampling Control Tests and Tests for Systems'  
Compliance with FFMIA Requirements
  - 370 Assess Controls on a Preliminary Basis
  - 380 Other Considerations
  - 390 Documentation
- Appendixes to Section 300:**
- 395 A Typical Relationships of Accounting Applications to Line  
Items/Accounts
  - 395 B Financial Statement Assertions and Potential  
Misstatements
  - 395 C Typical Control Activities
  - 395 D Selected Statutes Relevant to Budget Execution
  - 395 E Budget Execution Process
  - 395 F Budget Control Objectives
  - 395 F Budget Control Objectives—Federal Credit Reform Act Supplement  
Sup
  - 395 G Rotation Testing of Controls
  - 395 H Specific Control Evaluation Worksheet
  - 395 I Account Risk Analysis Form

---

## Contents

---

### **400 TESTING PHASE**

410 Overview

420 Consider the Nature, Timing, and Extent of Tests

430 Design Efficient Tests

440 Perform Tests and Evaluate Results

450 Sampling Control Tests

460 Compliance Tests

470 Substantive Tests—Overview

475 Substantive Analytical Procedures

480 Substantive Detail Tests

490 Documentation

#### **Appendixes to Section 400:**

495 A Determining Whether Substantive Analytical Procedures Will Be  
Efficient and Effective

495 B Example Procedures for Tests of Budget Information

495 C Guidance for Interim Testing

495 D Example of Audit Matrix with Statistical Risk Factors

495 E Sampling

495 F Manually Selecting a Dollar Unit Sampling

---

## Contents

---

### **500 REPORTING PHASE**

- 510 Overview
  - 520 Perform Overall Analytical Procedures
  - 530 Determine Adequacy of Audit Procedures and Audit Scope
  - 540 Evaluate Misstatements
  - 550 Conclude Other Audit Procedures
    - Inquiries of Attorneys
    - Subsequent Events
    - Management Representations
    - Related Party Transactions
  - 560 Determine Conformity With Generally Accepted Accounting Principles
  - 570 Determine Compliance with GAO/PCIE *Financial Audit Manual*
  - 580 Draft Reports
    - Financial Statements
    - Internal Control
    - Financial Management Systems
    - Compliance with Laws and Regulations
  
    - Other Information in the Accountability Report
  - 590 Documentation
- Appendixes to Section 500:**
- 595 A Example Auditor's Report—Unqualified
  - 595 B Suggested Modifications to Auditor's Report
  - 595 C Example Summary of Possible Adjustments
  - 595 D Example Summary of Unadjusted Misstatements

### **APPENDIXES**

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

### **GLOSSARY**

### **ABBREVIATIONS**

### **INDEX**

---

# SECTION 100

---

## Introduction

---

**Figure 100.1: Methodology Overview**

<b>Planning Phase</b>		<b>Section</b>
• Understand the entity's operations		220
• Perform preliminary analytical procedures		225
• Determine planning, design, and test materiality		230
• Identify significant line items, accounts, assertions, and RSSI		235
• Identify significant cycles, accounting applications, and financial management systems		240
• Identify significant provisions of laws and regulations		245
• Identify relevant budget restrictions		250
• Assess risk factors		260
• Determine likelihood of effective information system controls		270
• Identify relevant operations controls to evaluate and test		275
• Plan other audit procedures		280
• Plan locations to visit		285
<b>Internal Control Phase</b>		<b>Section</b>
• Understand information systems		320
• Identify control objectives		330
• Identify and understand relevant control activities		340
• Determine the nature, timing, and extent of control tests and of tests for systems' compliance with FFMIA requirements		350
• Perform nonsampling control tests and tests for systems' compliance with FFMIA requirements		360
• Assess controls on a preliminary basis		370
<b>Testing Phase</b>		<b>Section</b>
• Consider the nature, timing, and extent of tests		420
• Design efficient tests		430
• Perform tests and evaluate results		440
• Sampling control tests		450
• Compliance tests		460
• Substantive tests		470
••• Substantive analytical procedures		475
••• Substantive detail tests		480
<b>Reporting Phase</b>		<b>Section</b>
• Perform overall analytical procedures		520
• Determine adequacy of audit procedures and audit scope		530
• Evaluate misstatements		540
• Conclude other audit procedures:		550
• Inquire of attorneys		
• Consider subsequent events		
• Obtain management representations		
• Consider related party transactions		
• Determine conformity with generally accepted accounting principles		560
• Determine compliance with GAO/PCIE <i>Financial Audit Manual</i>		570
• Draft reports		580

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## **100 – INTRODUCTION**

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

### **OVERVIEW OF THE METHODOLOGY**

- .02 The overall purposes of performing financial statement audits of federal entities include providing decisionmakers (financial statement users) with assurance as to whether the financial statements are reliable, internal control is effective, and laws and regulations are complied with. To achieve these purposes, the approach to federal financial statement audits involves four phases:
- Plan the audit to obtain relevant information in the most efficient manner.
  - Evaluate the effectiveness of the entity's internal control and, for Chief Financial Officers (CFO) Act Agencies and components designated by OMB, whether financial management systems substantially comply with the requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA): federal financial management systems

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## 100 – INTRODUCTION

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requirements, applicable federal accounting standards,<sup>1</sup> and the *U.S. Government Standard General Ledger* (SGL) at the transaction level.<sup>2</sup>

- Test the significant assertions related to the financial statements and test compliance with laws and regulations.
- Report the results of audit procedures performed.

These phases are illustrated in figure 100.1 and are summarized below.<sup>3</sup>

### Planning Phase

- .03 Although planning continues throughout the audit, the objectives of this initial phase are to identify significant areas and to design efficient audit procedures. To accomplish this, the methodology includes guidance to help in
- understanding the entity's operations, including its organization, management style, and internal and external factors influencing the operating environment;
  - identifying significant accounts, accounting applications, and financial management systems; important budget restrictions, significant

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

<sup>2</sup> Testing for FFMIA is most efficiently accomplished, for the most part, as part of the work done in understanding agency systems in the Internal Control phase of the audit.

<sup>3</sup> The methodology presented is for performance of a financial statement audit. If the auditor is to use the work of another auditor, see FAM section 650 (under revision).

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## 100 – INTRODUCTION

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provisions of laws and regulations; and relevant controls over the entity's operations;

- determining the likelihood of effective information systems (IS) controls;
- performing a preliminary risk assessment to identify high-risk areas, including considering the risk of fraud; and
- planning entity field locations to visit.

### Internal Control Phase

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

- **Reliability of financial reporting**—transactions are properly recorded, processed, and summarized to permit the preparation of the principal statements and required supplementary stewardship information (RSSI) in accordance with generally accepted accounting principles (GAAP), and assets are safeguarded against loss from unauthorized acquisition, use, or disposition.
- **Compliance with applicable laws and regulations**—transactions are executed in accordance with (a) laws governing the use of budget authority and other laws and regulations that could have a direct and material effect on the principal statements or RSSI and (b) any other laws, regulations, and governmentwide policies identified by OMB in its audit guidance.

OMB audit guidance requires the auditor to test controls that have been properly designed to achieve these objectives and placed in operation, to support a low assessed level of control risk. This may be enough testing to give an opinion on internal control. GAO audits should be designed to give

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## 100 – INTRODUCTION

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an opinion on internal control.<sup>4</sup> If the auditor does not give an opinion, generally accepted government auditing standards (GAGAS) require the report to state whether tests were sufficient to give an opinion.

- .05 OMB's audit guidance includes a third objective of internal control, related to performance measures. The auditor is required to understand the components of internal control relating to the existence and completeness assertions and to report on internal controls that have not been properly designed and placed in operation, rather than to test controls.
- .06 This manual also provides guidance on evaluating internal controls related to operating objectives that the auditor elects to evaluate. Such controls include those related to safeguarding assets from waste or preparing statistical reports.
- .07 To evaluate internal control, the auditor identifies and understands the relevant controls and tests their effectiveness. Where controls are considered to be effective, the extent of substantive testing can be reduced.
- .08 The methodology includes guidance on
  - assessing specific levels of control risk,
  - selecting controls to test,
  - determining the effectiveness of IS controls, and
  - testing controls, including coordinating control tests with the testing phase.
- .09 Also, during the internal control phase, for CFO Act agencies and their components identified in OMB's audit guidance, the auditor should understand the entity's significant financial management systems and test their compliance with FFMIA requirements.

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

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## 100 – INTRODUCTION

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### Testing Phase

- .10 The objectives of this phase are to (1) obtain reasonable assurance about whether the financial statements are free from material misstatements, (2) determine whether the entity complied with significant provisions of applicable laws and regulations, and (3) assess the effectiveness of internal control through control tests that are coordinated with other tests.
- .11 To achieve these objectives, the methodology includes guidance on
- designing and performing substantive, compliance, and control tests;
  - designing and evaluating audit samples;
  - correlating risk and materiality with the nature, timing, and extent of substantive tests; and
  - designing multipurpose tests that use a common sample to test several different controls and specific accounts or transactions.

### Reporting Phase

- .12 This phase completes the audit by reporting useful information about the entity, based on the results of audit procedures performed in the preceding phases. This involves developing the auditor's report on the entity's (1) financial statements (also called Principal Statements) and other information (management's discussion and analysis [MD&A] or the overview, RSSI, other required supplementary information, and other accompanying information), (2) internal control, (3) whether the financial management systems substantially comply with FFMIA requirements, and (4) compliance with laws and regulations. To assist in this process, the methodology includes guidance on forming opinions on the principal statements and conclusions on internal control, as well as how to determine which findings should be reported. Also included is an example report designed to be understandable to the reader.

### RELATIONSHIP TO APPLICABLE STANDARDS

- .13 The following section describes the relationship of this audit methodology to applicable auditing standards, OMB guidance, and other policy requirements. It is organized into three areas:
- relevant auditing standards and OMB guidance,
  - audit requirements beyond the “yellow book,” and
  - auditing standards and other policies not addressed in this manual.

#### Relevant Auditing Standards and OMB Guidance

- .14 This manual provides a framework for performing financial statement audits in accordance with *Government Auditing Standards* (also known as generally accepted government auditing standards or GAGAS) issued by the Comptroller General of the United States ("yellow book"); incorporated generally accepted auditing standards (GAAS) and attestation standards established by the American Institute of Certified Public Accountants (AICPA); and OMB’s audit guidance.
- .15 This manual describes an audit methodology that both integrates the requirements of the standards and provides implementation guidance. The methodology is designed to achieve
- **effective audits** by considering compliance with the CFO Act, FFMIA, GAGAS, and OMB guidance;
  - **efficient audits** by focusing audit procedures on areas of higher risk and materiality and by providing an integrated approach designed to gather evidence efficiently;
  - **quality control** through an agreed-upon framework that can be followed by all personnel; and
  - **consistency of application** through a documented methodology.
- .16 The manual supplements GAGAS and OMB’s audit guidance. References are made to Statements on Auditing Standards (preceded by the prefix "AU") and Statements on Standards for Attestation Engagements (SSAE) (preceded by

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## 100 – INTRODUCTION

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the prefix "AT") of the *Codification of Statements on Auditing Standards*, issued by the AICPA, that are incorporated into GAGAS.

### Audit Requirements Beyond the “Yellow Book”

- .17 In addition to meeting GAGAS requirements, audits of federal entities to which OMB's audit guidance applies must be designed to achieve the following objectives described in OMB's audit guidance:
- responsibility for performing sufficient tests of internal controls that have been properly designed and placed in operation, to support a low assessed level of control risk;
  - expansion of the nature of controls that are evaluated and tested to include controls related to RSSI, budget execution, and compliance with laws and regulations;
  - responsibility to understand the components of internal control relating to the existence and completeness assertions relevant to the performance measures included in the MD&A, in order to report on controls that have not been properly designed and placed in operation;
  - responsibility to consider the entity's process for complying with 31 U.S.C. 3512 (the Federal Managers' Financial Integrity Act (FMFIA));
  - responsibility to perform tests at CFO Act agencies and components identified by OMB to report on the entity's financial management systems' substantial compliance with FFMIA requirements;
  - responsibility to test for compliance with laws, regulations, and governmentwide policies identified in OMB's audit guidance at CFO Act agencies (regardless of their materiality to the audit); and
  - responsibility to consider conformity of the MD&A, RSSI, required supplementary information, and other accompanying information with FASAB requirements and OMB guidance.

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## 100 – INTRODUCTION

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- .18 To help achieve the goals of the CFO Act, GAO audits should be designed to achieve the following objectives,<sup>5</sup> in addition to those described in OMB’s audit guidance:
- Provide an opinion on internal control.
  - Determine the effects of misstatements and internal control weaknesses on (1) the achievement of operations control objectives, (2) the accuracy of reports prepared by the entity, and (3) the formulation of the budget.
  - Determine whether specific control activities are properly designed and placed in operation, even if a poor control environment precludes their effectiveness.
  - Understand the components of internal control relating to the valuation assertion relevant to performance measures reported in the MD&A in order to report on controls that have not been properly designed and placed in operation.

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

- .19 This manual was designed to supplement financial audit and other policies and procedures adopted by GAO and Inspectors General (IGs). As such, it was not intended to address in detail all requirements. For example, report processing is not addressed.
- .20 Updates to this manual that include additional audit guidance and practice aids, such as checklists and audit programs, will be issued from time to time. GAO and a team representing the PCIE audit committee will be responsible for preparing the updates. There will be an exposure process for significant updates.

### **KEY IMPLEMENTATION ISSUES**

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

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<sup>5</sup> The manual refers specifically to objectives of GAO audits in various sections. Such objectives are optional for other audit organizations.

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## 100 – INTRODUCTION

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

### Audit Objectives

- .22 While certain federal entities are not subject to OMB audit guidance, financial statement audits of all federal entities should be conducted in accordance with this guidance to the extent applicable to achieve the audit's objectives. The manual generally assumes that the objective of the audit is to render an opinion on the current year financial statements, a report on internal control, and a report on compliance. Where these are not the objectives, the auditor should use judgment in applying the guidance. In some circumstances, the auditor will expect to issue a disclaimer on the current year financial statements (because of scope limitations). In these circumstances, the auditor may develop a multiyear plan to be able to render an opinion when the financial statements are expected to become auditable.

### Exercise of Professional Judgment

- .23 In performing a financial statement audit, the auditor should exercise professional judgment. Consequently, the auditor should tailor the guidance in the manual to respond to situations encountered in an audit. However, the auditor must exercise judgment properly, assuring that, at a minimum, the work meets professional standards. Proper application of professional judgment could result in additional or more extensive audit procedures than described in this manual.
- .24 In addition, when exercising judgment, the auditor should consider the needs of, and consult in a timely manner with, other auditors who plan to use the work being performed. In turn, the auditor should coordinate with other auditors whose work he or she wishes to use so that the judgments exercised can satisfy the needs of both auditors. For example, auditors of a consolidated entity (such as the US Government or an entire department or agency) are likely to plan to use the work of auditors of subsidiary entities

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## 100 – INTRODUCTION

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(such as individual departments and agencies or bureaus and components of a department). This coordination can result in more economy, efficiency, and effectiveness of government audits in general and avoid duplication of effort.

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

- quantifying planning materiality, design materiality, and test materiality and using materiality as one consideration in determining the extent of testing (see section 230);
- specifying a minimum level of substantive assurance based on the assessed combined risk, analytical procedures, and detail tests (see sections 470, 480, and 495 D);
- documenting whether selections are samples (intended to be representative and projected to populations) or nonsampling selections that are not projectible (see section 480);
- using sampling methods, such as dollar-unit sampling, classical variables estimation sampling, or classical probability proportional to size (PPS) sampling, for substantive or multipurpose testing (including nonstatistical sampling) (see section 480);
- using sampling for control testing, other than attribute sampling using the tables in section 450 to determine sample size when not performing a multipurpose test;
- using sampling for compliance testing of laws and regulations, other than attribute sampling using the tables in section 460 to determine sample size when not performing a multipurpose test; and
- placing complete or partial reliance on analytical procedures, using test materiality to calculate the limit. The limit is the amount of difference between the expected and recorded amounts that can be accepted without further investigation (see section 475).

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## 100 – INTRODUCTION

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### References to Positions

- .26 Various sections of this manual make reference to consultation with audit management and/or persons with technical expertise to obtain approval or additional guidance. Key consultations should be documented in the audit workpapers. Each audit organization should document, in the workpapers or its audit policy manual, the specific positions of persons who will perform these functions. An IG using a firm to perform an audit in accordance with this manual should clarify and document the positions of the persons the firm should consult in various circumstances.
- The **Assistant Director** is the top person responsible for the day-to-day conduct of the audit.
  - The **Audit Director** is the senior manager responsible for the technical quality of the financial statement audit, reporting to the Assistant Inspector General for Audit or, at GAO, to the Managing Director.
  - The **Reviewer** is the senior manager responsible for the quality of the auditor's reports, reporting to the Assistant Inspector General for Audit (or higher position) or, at GAO, is the Managing Director or the second partner. The Reviewer may consult with others.
  - The **Statistician** is the person the auditor consults for technical expertise in areas such as audit sampling, audit sample evaluation, and selecting entity field locations to visit.
  - The **Data Extraction Specialist** is the person with technical expertise in extracting data from agency records.
  - The **Technical Accounting and Auditing Expert** is the senior manager reporting to the Assistant Inspector General for Audit or higher or, at GAO, is the Chief Accountant. The Technical Accounting and Auditing Expert advises on accounting and auditing professional matters and related national issues. The Technical Accounting and Auditing Expert reviews reports on financial statements and reports that contain opinions on financial information.
  - The **Office of General Counsel** (OGC) provides assistance to the auditor in (1) identifying provisions of laws and regulations to test,

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## 100 – INTRODUCTION

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(2) identifying budget restrictions, and (3) identifying and resolving legal issues encountered in the financial statement audit, such as evaluating potential instances of noncompliance.

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

### Use of Information Systems Auditors

- .27 The audit standards (SAS 94) require that the audit team possess sufficient knowledge of information systems (IS) to determine the effect of IS on the audit, to understand the IS controls, and to design and perform tests of IS controls and substantive tests. This is generally done by having IS auditors as part of the audit team. IS auditors should possess sufficient technical knowledge and experience to understand the relevant concepts discussed in the manual and to apply them to the audit. While the auditor is ultimately responsible for assessing inherent and control risk, assessing the effectiveness of IS controls requires a person with IS audit technical skills. Specialized technical skills generally are needed in situations where, (1) the entity's systems, automated controls, or the manner in which they are used in conducting the entity's business are complex, (2) significant changes have been made to existing systems or new systems implemented, (3) data are extensively shared among systems, (4) the entity participates in electronic commerce, (5) the entity uses emerging technologies, or (6) significant audit evidence is available only in electronic form. Appendix V of GAO's *Federal Information System Controls Audit Manual* (FISCAM) contains examples of knowledge, skills, and abilities needed by IS auditors. Certain financial auditors also may possess IS audit technical skills. In some cases, the auditor may require outside consultants to provide these skills.

### Compliance With Policies and Procedures in the Manual

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

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## 100 – INTRODUCTION

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- **Must:** Compliance with this policy or procedure is mandatory unless an exception is approved in writing by the Reviewer,<sup>6</sup> such as in certain instances when a disclaimer of opinion is anticipated.
- **Should:** Compliance with this policy or procedure is expected unless there is a reasonable basis for departure from it. Any such departure and the basis for it are to be documented in a memorandum. The Assistant Director should approve this memorandum and copies should be sent to the Audit Director and the Reviewer.
- **Generally Should:** Compliance with this policy or procedure is strongly encouraged. Departure from such policy or procedure should be discussed with the Assistant Director or the audit manager.
- **May:** Compliance with this policy or procedure is optional.

When the auditor deviates from a policy or procedure that is expressed by use of the term "must" or "should" in the FAM, he or she should consider the needs of, and consult in a timely manner with, other auditors who plan to use the work of the auditor and provide an opportunity for the other auditors to review the documentation explaining these deviation decisions.

### Use of Technical Terms

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

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<sup>6</sup> Capitalized positions are described in paragraph 100.25.

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## **100 - INTRODUCTION**

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### Reference to GAO/PCIE *Financial Audit Manual*

- .30 When cited in workpapers, correspondence, or other communication, the letters “FAM” should precede section or paragraph numbers from this manual. For example, this paragraph should be referred to as FAM 100.30.