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CPE

Yellow Book Financial Audits

Yellow Book Financial Audits

By William Blend, CPA, CFE

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Use of Materials

This course manual accompanies all formats in which the course is offered, including self-study text, self-study online, group study, in-firm, and other formats, as applicable. Specific instructions for users of the various formats are included in this section.

Continuing Professional Education (CPE) is required for CPAs to maintain their professional competence and provide quality professional services. CPAs are responsible for complying with all applicable CPE requirements, rules, and regulations of state licensing bodies, other governmental entities, membership associations, and other professional organizations or bodies.

Professional standards for CPE programs are issued jointly by the American Institute of Certified Public Accountants (AICPA) and the National Association of State Boards of Accountancy (NASBA) to provide a framework for the development, presentation, measurement, and reporting of CPE programs. These standards are entitled *Joint AICPA/NASBA Statement on Standards for Continuing Professional Education Programs* (CPE standards), and are available as part of the AICPA's *Professional Standards* three-volume set, either in paperback or as on online subscription through the AICPA's *Online Professional Library*.

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The CPE standards require that self study programs include review questions (also known as knowledge check questions) that provide feedback to both correct and incorrect responses. Note that these questions are provided only as learning aids and do not constitute a final examination.

Requirements for Claiming and Receiving CPE Credit

CPE standards place responsibility on both the individual participant and the program sponsor to maintain a record of attendance at a CPE program. CPAs who participate in only part of a CPE program should only claim CPE credit for the portion that they attended or completed.

CPE participants must document their claims of CPE credit. Examples of acceptable evidence of completion include:

- for group and independent study programs, a certificate or other verification supplied by the CPE program sponsor.
- for self-study programs, a certificate supplied by the CPE program sponsor after satisfactory completion of an examination.

Participants in group study and other live presentations will receive a completion certificate from the program sponsor. CPE program sponsors are required to keep documentation on programs for five years, including records of participation.

All self-study participants must complete the exam <u>within one year of date of course purchase</u> in order to receive a certificate indicating satisfactory completion of the CPE program.

- ➢ When purchased as a self-study course in text format, the exam is located in the *Examination* section at the end of the course manual.

- The course code number for both the self study exam and the self study evaluation can be found in the *Examination's* introductory material.
- Participants may either complete the self-study exam and evaluation online at **https://cpegrading.aicpa.org** or use the paper answer sheet and evaluation forms included with the course materials. Participants must provide the unique serial number printed on the examination answer sheet. If using the paper forms, participants should mail the original answer sheet and course evaluation form in the pre-addressed envelope. Photocopies or faxes of the original forms are not acceptable. The paper grading process averages five to seven business days from date of receipt. During peak reporting periods (June, September, and December), the processing time may be 10 to 15 business days. Self-study participants must achieve a minimum passing grade of at least 70 percent to qualify for CPE credit.
    - Upon achieving a passing grade, participants receive a certificate displaying the number of CPE credits earned based on a 50-minute hour, in compliance with CPE standards.
        - If the exam is completed online, the completion certificate is provided online, which may be printed or saved in .pdf format. Also, the grading system maintains a transcript of the participants' completed courses.
        - If the answer key is mailed in, participants receive the completion certificate in the mail.
    - If a passing grade is not achieved, the participants are notified.
        - If a passing grade is not achieved and the participant completed the exam online, the grading system provides immediate online notification of the score as well as instructions on how to re-take the exam. Participants who do not pass the online exam within three attempts must mail in the examination answer key.
        - If a passing grade is not achieved and the participant mailed in the exam, the participant is mailed a notification of the exam score and an answer sheet so that the exam may be re-taken.

Program Evaluations

The information accumulated from participant evaluation forms is an important element in our continual efforts to provide high quality continuing education for the profession. Participants in group study and other live presentations should return their evaluation forms prior to departing their program sessions. Self-study participants should either mail the completed evaluation form along with the examination answer sheet in the envelope provided, or complete the course evaluation online. Your comments are very important to us.

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Table of Contents

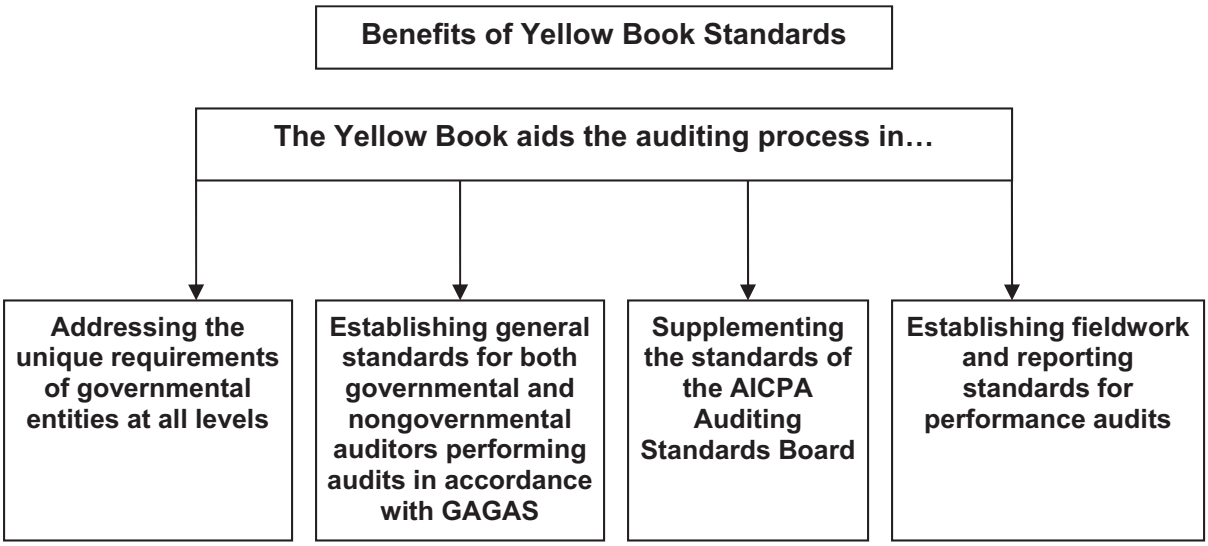
Users of this course material are encouraged to visit the AICPA website at www.aicpa.org/CPESupplements to access supplemental learning material reflecting recent developments that may be applicable to this course. The AICPA anticipates that supplemental materials will be made available on a quarterly basis.

Overview

Generally Accepted Government Auditing Standards (Yellow Book)

Rationale for GAGAS

Generally accepted government auditing standards (GAGAS), issued by the U.S. Government Accountability Office (GAO), is the statement of auditing standards for audits of government organizations, functions, activities, and programs, as well as for government assistance received by nonfederal entities. The requirements of GAGAS apply to audits of governmental entities, programs, activities, and functions of government assistance administered by contactors, nonfederal entities, and other entities when the use of GAGAS is required or voluntarily followed. Known widely as the "Yellow Book," GAGAS aids the auditing process in the following four ways:



To meet ongoing demands for more responsive and cost-effective government, policy makers and managers need reliable financial and performance information. The assurance that auditors provide about that information, as well as about the internal processes that produce it, is a critical component of fiscal integrity and accountability. GAGAS help provide accountability and assistance to public officials and employees in carrying out their responsibilities. Auditing provides credibility to the information reported by, or obtained by, management.

The terms GAS and GAGAS are often used interchangeably; however, in this course, the terms GAS, GAGAS, and Yellow Book are all used interchangeably.

Brief History of the GAS

Beginning in the mid-1960s, both the number and the dollar amount of federal government programs and services increased substantially. This increase brought with it a demand for full accountability from those entrusted with public funds and the responsibility for managing government programs and services properly.

Origin of the Standards

In 1969, the Comptroller General of the United States held a series of meetings with a group of state auditors and federal officials. These meetings identified a need to improve government auditing. One of the areas identified was the absence of formal GAS. In July 1969, the GAO initiated plans for an audit standards work group charged with the objective of developing GAS.

In 1970, the audit standards work group started the survey and research work on which the original 1972 Standards were based. The work group included representatives from the GAO, federal departments and agencies, state and local government auditors, and professional organizations including the AICPA. Assistance was also provided by academics and public interest groups. In June 1972, the Comptroller General issued the original version of the Yellow Book, entitled *Standards for Audits of Governmental Organizations, Programs, Activities & Functions*.

Yellow Book Revisions

In 1979, the GAO started a project to revise the Standards. Based on comments and suggestions the GAO had received since the Standards were originally issued, a draft of proposed revised Standards was prepared and released for comment in August 1980. Comments received were analyzed and evaluated for appropriate consideration in arriving at the final draft Standards. The 1981 revision of GAGAS was signed by the Comptroller General on February 27, 1981.

In November 1985, the GAO started a project to clarify, update, and revise the 1981 revision of the Yellow Book. In December 1985, the Comptroller General appointed an Auditing Standards Advisory Council (ASAC) to advise him and the GAO on revising the Standards. The ASAC comprised members from federal, state, and local governments; public accounting; academia; and other special interest groups.

On March 16, 1987, an exposure draft (ED) was released for comment and was sent to audit officials at all levels of government and members of the public accounting profession, academia, professional organizations, and public interest groups. Comments received were analyzed and evaluated, and appropriate changes were made in the final draft. The final revised Standards were released in August 1988, superseding the 1981 revision.

In July 1993, an ED was released proposing changes to the 1988 Yellow Book revision. A revision, entitled *Government Auditing Standards: 1994 Revision*, was released on June 6, 1994. Its provisions were effective for financial audits of periods ending on or after January 1, 1995; and performance audits beginning on or after January 1, 1995.

After the issuance of the 1994 revision of the Yellow Book, three amendments were issued as follows:

- Amendment No. 1: *Documentation Requirements When Assessing Control Risk at Maximum for Controls Significantly Dependent Upon Computerized Information Systems*, issued May 1999
- Amendment No. 2: *Auditor Communication*, issued July 1999
- Amendment No. 3: *Independence*, issued January 2002

In June 2003, the GAO released an omnibus revision to the Yellow Book. The standards became applicable for financial audits and attestation engagements of periods ending on or after January 1, 2004, and for performance audits beginning on or after January 1, 2004.

In July 2007, the GAO issued an omnibus revision to the Yellow Book. The 2007 Yellow Book became applicable for financial audits and attestation engagements for periods beginning on or after January 1, 2008, and for performance audits beginning on or after January 1, 2008.

In December 2011, the GAO issued the *Government Auditing Standards (2011 Revision)*, which superseded the 2007 revision. The 2011 revision of GAS is currently effective.

Acquiring the Government Auditing Standards Publication

Obtaining a copy of the GAO *Government Auditing Standards (2011 Revision)* is highly recommended for participants of this course.

Printed copies of GAGAS are only available from the U.S. Government Bookstore at the Government Printing Office. A copy of the publication may be obtained online at the U.S. Government Bookstore as follows:

Paperback: http://bookstore.gpo.gov (Stock Number 020-000-00291-3)

E-Book: http://bookstore.gpo.gov (Stock Number 999-000-44443-1)

In addition, PDF and TXT versions can be downloaded at www.gao.gov/yellowbook.

Advisory Council on GAGAS

In 1985, the GAO named a council to provide advice and guidance on GAGAS. The purpose of this GAS Advisory Council is to work with the GAO to keep the Yellow Book current through issuance of revisions and guidance.

The Council helps to ensure the continued development of Standards that are generally accepted by the government audit community. Its members provide strong collective knowledge of financial, compliance, and performance auditing and program evaluation at all levels of government. Council members, selected from nominations received from relevant professional organizations, serve staggered terms of two, three, or four years to provide continuity.

The GAO and the Council issue EDs of individual areas for comment subsequent to final revisions to Standards. This is similar to the method used by the AICPA's Auditing Standards Board with SAS releases (post-SAS 122). The revisions are codified into the Standards.

The GAO responds to requests regarding any requirement or interpretation in the Yellow Book. Information on submitting inquiries is available at www.gao.gov/yellowbook.

Chapter 1

GOVERNMENT AUDITING: FOUNDATION AND ETHICAL PRINCIPLES

LEARNING OBJECTIVES

After completing this chapter, you should be able to do the following:

- Recognize why engagements are performed under generally accepted government auditing standards (GAGAS or the Yellow Book).
- Identify the ethical principles presented in chapter 1 of the Yellow Book.
- Recognize why the ethical principles are so important in GAGAS.

INTRODUCTION

The concept of accountability for use of public resources and government authority is key to America's governing processes. Management and officials entrusted with public resources are responsible for carrying out public functions and providing service to the public legally, effectively, efficiently, economically, ethically, and equitably within the context of the statutory boundaries of the specific government program.

As reflected in applicable laws, regulations, agreements, and standards, management and officials of government programs are responsible for providing reliable, useful, and timely information for transparency and accountability of these programs and their operations. Legislators, oversight bodies,

those charged with governance, and the public need to know whether (1) entities manage government resources and use their authority properly and in compliance with laws and regulations; (2) government programs are achieving their objectives and desired outcomes; and (3) government services are provided effectively, efficiently, economically, ethically, and equitably.

Government auditing is essential in providing government accountability to legislators, oversight bodies, those charged with governance, and the public. Audits and attestation engagements provide an independent, objective, nonpartisan assessment of the stewardship, performance, or cost of government policies, programs, or operations, depending upon the type and scope of the audit.

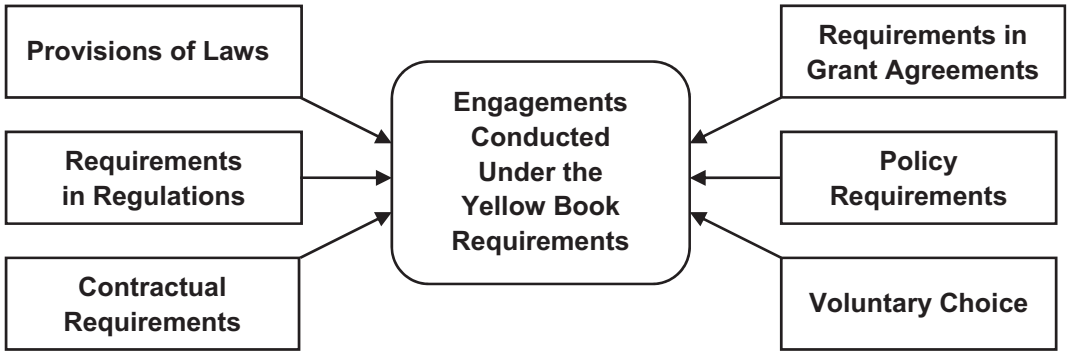
Purpose and Applicability of GAGAS

The professional standards and guidance contained in Government Auditing Standards, commonly referred to as GAGAS or the Yellow Book, provide a framework for conducting high quality audits with competence, integrity, objectivity, and independence. The Yellow Book standards are for use by auditors of governmental entities and entities that receive federal awards and audit organizations performing GAGAS audits. GAGAS contain requirements and guidance dealing with ethics, independence, auditors' professional judgment and competence, quality control, performance of the audit, and reporting.

Audits performed under GAGAS provide information used for oversight, accountability, transparency, and improvements of government programs and operations. GAGAS contain requirements and guidance to assist auditors in objectively acquiring and evaluating sufficient, appropriate evidence and reporting the results. When auditors perform their work in this manner and comply with GAGAS in reporting the results, their work can lead to improved government management, better decision making and oversight, effective and efficient operations, and accountability and transparency for resources and results.

As illustrated below provisions of laws, regulations, contracts, grant agreements, and policies frequently require audits in accordance with GAGAS. Many auditors and audit organizations also voluntarily choose to perform their work in accordance with GAGAS.

Why Are Yellow Book Engagements Performed?



The requirements and guidance in the Yellow Book apply to audits and attestation engagements of governmental entities, programs, activities, and functions, and of government assistance administered by contractors, not-for-profit entities, and other nongovernmental entities when the use of GAGAS is required or is voluntarily followed.

Knowledge Check

1. The requirements and guidance in the Yellow Book apply to audits and attestation engagements for the following entities, EXCEPT for

    a. For-profit organizations.
    b. Government functions.
    c. Government programs.
    d. Government activities.

Auditors, Audit Organizations, and Audits

As illustrated in the following section, the Yellow Book describes the usage of the terms *auditor* and *audit organizations*.

GAGAS Definitions of *Auditor* and *Audit Organizations*

The term *auditor* as it is used throughout GAGAS describes individuals performing work under GAGAS (including audits and attestation engagements) regardless of job title. Therefore, individuals who may have the titles auditor, analyst, practitioner, evaluator, inspector, or other similar titles are considered auditors in GAGAS.

The term *audit organizations* as it is used throughout GAGAS refers to government audit organizations as well as public accounting or other firms that perform audits and attestation engagements using GAGAS.

The term *audit* refers to financial audits, attestation engagements, and performance audits conducted in accordance with GAGAS.

A government audit organization can be structurally located within or outside the audited entity. Audit organizations that report to third parties external to the entity under audit are considered to be external audit organizations. Audit organizations that are accountable to top management and those charged with governance of the audited entity, and do not generally issue their reports to third parties external to the entity under audit, are considered internal audit organizations.

Some government audit organizations represent a unique hybrid of external auditing and internal auditing in their oversight role for the entities they audit. These audit organizations have external reporting requirements consistent with the reporting requirements for external auditors while at the same time are part of their respective agencies. These audit organizations often have a dual reporting responsibility to their legislative body as well as to the agency head and management. For purposes of GAGAS, these organizations are considered external audit organizations.

Ethical Principles

The ethical principles contained in the following sections provide the foundation, discipline, and structure as well as the climate, which influence the application of GAGAS. The ethical principles set forth fundamental principles rather than establishing specific standards or requirements.

Since auditing is essential to government accountability to the public, the public expects audit organizations and auditors who conduct their work in accordance with GAGAS to follow ethical principles. Management of the audit organization sets the tone for ethical behavior throughout the organization by maintaining an ethical culture, clearly communicating acceptable behavior and expectations to each employee, and creating an environment that reinforces and encourages ethical behavior throughout all levels of the organization. The ethical tone maintained and demonstrated by management and staff is an essential element of a positive ethical environment for the audit organization.

Conducting audit work in accordance with ethical principles is a matter of personal and organizational responsibility. Ethical principles apply in preserving auditor independence, taking on only work that the auditor is competent to perform, performing high-quality work, and following the applicable standards cited in the audit report. Integrity and objectivity are maintained when auditors perform their work and make decisions that are consistent with the broader interest of those relying on the auditors' report, including the public.

Other ethical requirements or codes of professional conduct may also be applicable to auditors who conduct audits in accordance with GAGAS. For example, individual auditors who are members of professional organizations or are licensed or certified professionals may also be subject to ethical requirements of those professional organizations or licensing bodies. Auditors in governmental entities may also be subject to government ethics laws and regulations.

The ethical principles that guide the work of auditors who conduct audits in accordance with GAGAS are

- the public interest;
- integrity;
- objectivity;
- proper use of government information, resources, and positions; and
- professional behavior.

The Public Interest

The public interest is defined as the collective well-being of the community of people and entities the auditors serve. Observing integrity, objectivity, and independence in discharging their professional responsibilities assists auditors in meeting the principle of serving the public interest and honoring the public trust. These principles are fundamental to the responsibilities of auditors and critical in the government environment.

A distinguishing mark of an auditor is acceptance of responsibility to serve the public interest. This responsibility is critical when auditing in the government environment. GAGAS embody the concept of accountability for public resources, which is fundamental to serving the public interest.

Integrity

Public confidence in government is maintained and strengthened by auditors performing their professional responsibilities with integrity. Integrity includes auditors conducting their work with an attitude that is objective, fact-based, nonpartisan, and nonideological with regard to audited entities and users of the auditors' reports. Within the constraints of applicable confidentiality laws, rules, or policies, communications with the audited entity, those charged with governance, and the individuals contracting for or requesting the audit are expected to be honest, candid, and constructive.

Making decisions consistent with the public interest of the program or activity under audit is an important part of the principle of integrity. In discharging their professional responsibilities, auditors may encounter conflicting pressures from management of the audited entity, various levels of government, and other likely users. Auditors may also encounter pressures to violate ethical principles to inappropriately achieve personal or organizational gain. In resolving those conflicts and pressures, acting with integrity means that auditors place priority on their responsibilities to the public interest.

Objectivity

The credibility of auditing in the government sector is based on auditors' objectivity in discharging their professional responsibilities. Objectivity includes being independent of mind and appearance when providing audit and attestation engagements, maintaining an attitude of impartiality, and having intellectual honesty. Maintaining objectivity includes a continuing assessment of relationships with audited entities and other stakeholders in the context of the auditor's responsibility to the public. The concepts of objectivity and independence are closely related. Independence impairments impair objectivity.

Proper Use of Government Information, Resources, and Positions

Government information, resources, and positions are to be used for official purposes and not inappropriately for the auditor's personal gain or in a manner contrary to law or detrimental to the legitimate interests of the audited entity or the audit organization. This concept includes the proper handling of sensitive or classified information or resources.

In the government environment, the public's right to the transparency of government information has to be balanced with the proper use of that information. In addition, many government programs are subject to laws and regulations dealing with the disclosure of information. To accomplish this balance, exercising discretion in the use of information acquired in the course of the auditors' duties is an important part in achieving this goal. Improperly disclosing any such information to third parties is not an acceptable practice.

Accountability to the public for the proper use and prudent management of government resources is an essential part of auditors' responsibilities. Protecting and conserving government resources and using them appropriately for authorized activities is an important element in the public's expectations for auditors.

Misusing the position of an auditor for personal gain violates an auditor's fundamental responsibilities. An auditor's credibility can be damaged by actions that could be perceived by an objective third party with knowledge of the relevant information as improperly benefiting an auditor's personal financial interests or those of an immediate or close family member; a general partner; an organization for which the auditor serves as an officer, director, trustee, or employee; or an organization with which the auditor is negotiating concerning future employment.

Professional Behavior

High expectations for the auditing profession include compliance with laws and regulations and avoidance of any conduct that might bring discredit to auditors' work, including actions that would cause an objective third party with knowledge of the relevant information to conclude that the auditors' work was professionally deficient. Professional behavior includes auditors putting forth an honest effort in performance of their duties and professional services in accordance with the relevant technical and professional standards.

Knowledge Check

2. In GAGAS audits, under which ethical principle should auditors be independent of mind and appearance when providing audit and attestation engagements?

    a. The public interest.
    b. Objectivity.
    c. Professional behavior.
    d. Proper use of government information, resources, and position.

Key Foundational Points

1. Government auditing is essential in providing government accountability to legislators, oversight bodies, those charged with governance, and the public.
2. Management sets the tone for ethical behavior throughout the organization.
3. The ethical principles presented in chapter 1 of the Yellow Book provide the foundation, discipline, and structure as well as the climate, which influence the application of GAGAS.
4. Conducting audit work in accordance with ethical principles is a matter of personal and organizational responsibility.

Chapter 2

Standards for Use and Application of GAGAS

Learning Objectives

After completing this chapter, you should be able to do the following:

- Identify the types of engagements that can be performed in accordance with generally accepted government auditing standards (GAGAS, or the Yellow Book).
- Identify the relationship between GAGAS and AICPA standards.
- Identify the two categories of professional requirements used in the Yellow Book.
- Recognize the relationship between GAGAS and other professional standards.

Introduction

Chapter 2 of the Yellow Book establishes requirements and provides guidance for audits performed in accordance with GAGAS. Chapter 2 also identifies the types of audits that may be performed in accordance with GAGAS, explains the terminology that GAGAS uses to identify requirements, explains the relationship between GAGAS and other professional standards, and provides requirements for stating compliance with GAGAS in the auditors' report.

Types of GAGAS Audits and Attestation Engagements

This section describes the types of audits and attestation engagements that audit organizations may perform under GAGAS. This description is not intended to limit or require the types of audits or attestation engagements that may be performed under GAGAS.

Where Do We Begin?

All audits and attestation engagements begin with objectives, and those objectives determine the type of audit and attestation engagement to be performed and the applicable standards to be followed. Yellow Book classifications of audits and attestation engagements are

- financial audits,
- attestation engagements, and
- performance audits.

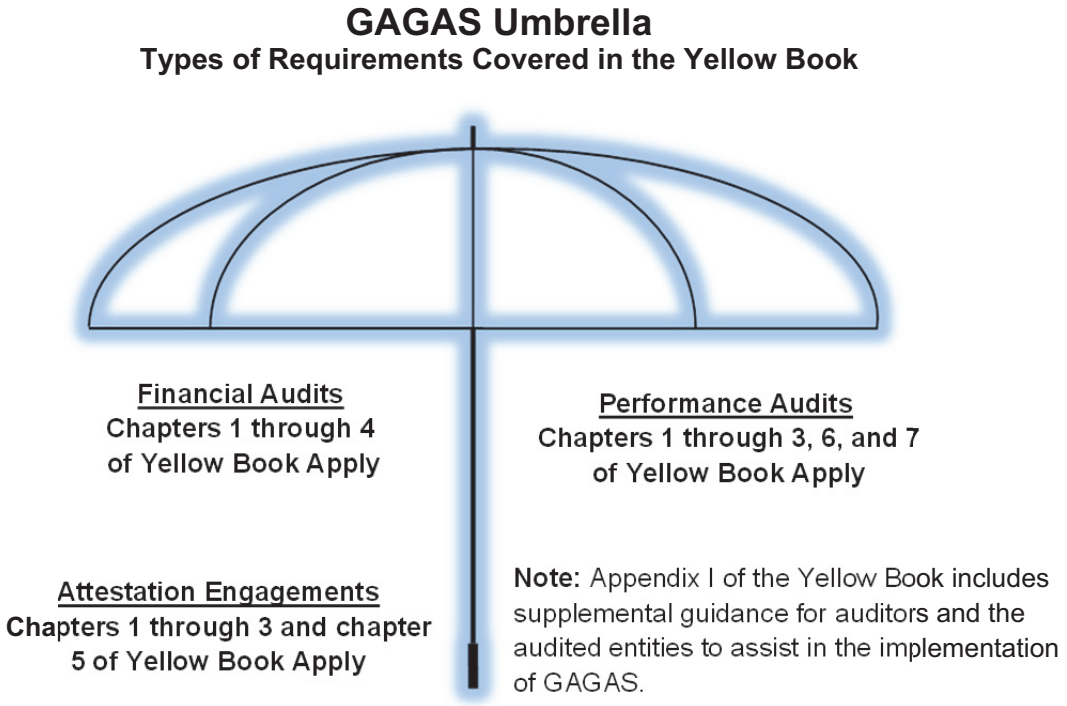
How Do We Know Which Standards to Follow?

In some audits and attestation engagements, the standards applicable to the specific audit objective will be apparent. For example, if the audit objective is to express an opinion on financial statements, the standards for financial audits apply. However, some engagements may have multiple or overlapping objectives. For example, if the objectives are to determine the reliability of performance measures, this work can be done in accordance with either the standards for attestation engagements or for performance audits.

In cases in which there is a choice between applicable standards, auditors should evaluate users' needs and the auditors' knowledge, skills, and experience in deciding which standards to follow.

Which GAGAS Requirements Apply to My Engagement?

GAGAS requirements apply to the types of audit and attestation engagements that may be performed under GAGAS as illustrated in the following:



What Are Financial Audits?

Financial audits provide an independent assessment of whether an entity's reported financial information (financial condition, results, and use of resources) are presented fairly in accordance with recognized criteria. GAGAS incorporates by reference the AICPA SASs, therefore the auditor is required to follow generally accepted auditing standards (GAAS) and the standards contained in chapters 1–4 of the Yellow Book when performing a GAGAS audit.

Financial Audits Performed Under GAGAS Include Financial Statement Audits and Other Related Financial Audits:

Financial Statement Audits	Other Types of Financial Audits
The primary purpose of a financial statement audit is to provide an opinion (or disclaim an opinion) about whether an entity's financial statements are presented fairly in all material respects in conformity with accounting principles generally accepted in the United States of America, or with an applicable financial reporting framework. GAGAS contain additional requirements for auditors to report on internal control over financial reporting and on compliance with provisions of laws, regulations, contracts, and grant agreements that have a material effect on the financial statements.	Other types of financial audits under GAGAS entail various scopes of work, including (1) obtaining sufficient, appropriate evidence to form an opinion on financial statements prepared in accordance with a special purpose framework or on specified elements, accounts, or items of a financial statement; (2) issuing letters for underwriters and certain other requesting parties; and (3) auditing compliance with applicable compliance requirements relating to one or more government programs.

Knowledge Check

1. GAGAS provides guidance for other types of financial audits, including each of the following, EXCEPT for

    a. Financial statements prepared in accordance with a special purpose framework.
    b. Issuing letters for underwriters and certain other requesting parties.
    c. Not-for-profit entities that do not receive or administer federal funds or grants.
    d. Obtaining sufficient appropriate evidence to form an opinion on single financial statements, specified elements, accounts, or items of a financial statement.

What Are Attestation Engagements?

Attestation engagements can cover a broad range of financial or nonfinancial objectives about the subject matter or assertion depending on the users' needs. GAGAS incorporates by reference the AICPA SSAEs. The AICPA standards recognize attestation engagements that result in an examination, a review, or an agreed-upon procedures report on a subject matter or on an assertion about a subject matter that is the responsibility of another party.

The Three Types of Attestation Engagements
Examination Consists of obtaining sufficient, appropriate evidence to express an opinion on whether the subject matter is based on (or in conformity with) the criteria in all material respects or the assertion is presented (or fairly stated), in all material respects, based on the criteria.
Review Consists of sufficient testing to express a conclusion about whether any information came to the auditors' attention on the basis of the work performed that indicates the subject matter is not based on (or not in conformity with) the criteria or the assertion is not presented (or not fairly stated) in all material respects based on the criteria. Auditors should not perform review-level work for reporting on internal control or compliance with provisions of laws and regulations.
Agreed-Upon Procedures Consists of auditors performing specific procedures on the subject matter and issuing a report of findings based on the agreed-upon procedures. In an agreed-upon procedures engagement, the auditor does not express an opinion or conclusion, but only reports on agreed-upon procedures in the form of procedures and findings related to the specific procedures applied.

Example attestation engagements that can be performed in accordance with GAGAS include

- prospective financial or performance information;
- management's discussion and analysis (MD&A) presentation;
- an entity's internal control over financial reporting;
- the effectiveness of an entity's internal control over compliance with specified requirements, such as those governing the bidding for, accounting for, and reporting on grants and contracts; and
- an entity's compliance with requirements of specified laws, regulations, policies, contracts, or grants.

Knowledge Check

2. The Yellow Book covers the following attestation engagements, EXCEPT for

    a. Compilations.
    b. Examinations.
    c. Reviews.
    d. Agreed-upon procedures.

What Are Performance Audits?

Performance audits are defined as engagements that provide findings or conclusions based on an evaluation of sufficient, appropriate evidence against criteria related to objectives of program performance. Performance audits provide objective analysis to assist management and those charged with governance and oversight in using the information to improve program performance and operations, reduce costs, facilitate decision making by parties with responsibility to oversee or initiate corrective action, and contribute to public accountability. The term "program" is used in Yellow Book to include governmental entities, organizations, programs, activities, and functions.

For performance audits, GAGAS does not incorporate other standards by reference, but recognizes that the auditor may use or may be required to use other professional standards in conjunction with GAGAS.

Performance audit objectives may vary widely and include assessments of program effectiveness, economy, and efficiency; internal control; compliance; and prospective analyses. These overall objectives are not mutually exclusive. Thus, a performance audit may have more than one overall objective. For example, a performance audit with an initial objective of program effectiveness may also involve an underlying objective of evaluating internal controls to determine the reasons for a program's lack of effectiveness or how effectiveness can be improved.

Examples of the Various Types of the Performance Audit Objectives	
Program Effectiveness and Results Audit Objectives	Program effectiveness and results audit objectives are frequently interrelated with economy and efficiency objectives. Audit objectives that focus on program effectiveness and results typically measure the extent to which a program is achieving its goals and objectives. Audit objectives that focus on economy and efficiency address the costs and resources used to achieve program results. The following are selected examples of program effectiveness and results audit objectives: ▪ Assessing the extent to which legislative, regulatory, or organizational goals and objectives are being achieved ▪ Assessing the relative ability of alternative approaches to yield better program performance or eliminate factors that inhibit program effectiveness ▪ Analyzing the relative cost-effectiveness of a program or activity, focusing on combining cost information with information about outputs or the benefit provided or with outcomes or the results achieved

Examples of the Various Types of the Performance Audit Objectives (continued)	
Internal Control Audit Objectives	Internal control audit objectives relate to an assessment of one or more components of an organization's system of internal control that is designed to provide reasonable assurance of achieving effective and efficient operations, reliable financial and performance reporting, or compliance with applicable laws and regulations. Internal control objectives also may be relevant when determining the cause of unsatisfactory program performance. Internal control comprises the plans, policies, methods, and procedures used to meet the organization's mission, goals, and objectives. Internal control includes the processes and procedures for planning, organizing, directing, and controlling program operations, and management's system for measuring, reporting, and monitoring program performance. Selected examples of audit objectives related to internal control include an assessment of the extent to which internal control provides reasonable assurance about whether ▪ organizational missions, goals, and objectives are achieved effectively and efficiently; ▪ resources are used in compliance with laws, regulations, or other requirements; and ▪ resources, including sensitive information accessed or stored outside the organization's physical perimeter, are safeguarded against unauthorized acquisition, use, or disposition.
Compliance Audit Objectives	Compliance audit objectives relate to an assessment of compliance with criteria established by provisions of laws, regulations, contracts, and grant agreements, and other requirements that could affect the acquisition, protection, use, and disposition of the entity's resources and the quantity, quality, timeliness, and cost of services the entity produces and delivers. Compliance requirements can be either financial or nonfinancial. Selected examples of compliance objectives include determining whether ▪ the purpose of the program, the manner in which it is to be conducted, the services delivered, the outcomes, or the population it serves is in compliance with laws, regulations, provisions of contracts or grant agreements, and other requirements;

Examples of the Various Types of the Performance Audit Objectives (continued)	
	▪ government services and benefits are distributed or delivered to citizens based on the individual's eligibility to obtain those services and benefits; and ▪ incurred or proposed costs are in compliance with applicable laws, regulations, and contracts or grant agreements.
Prospective Analysis Audit Objectives	Prospective analysis audit objectives provide analysis or conclusions, about information that is based on assumptions about events that may occur in the future along with possible actions that the audited entity may take in response to the future events. Selected examples of objectives pertaining to prospective analysis include providing conclusions based on ▪ current and projected trends and future potential impact on government programs and services; ▪ program or policy alternatives, including forecasting program outcomes under various assumptions; and ▪ policy or legislative proposals, including advantages, disadvantages, and analysis of stakeholder views.

Knowledge Check

3. The Yellow Book states that performance audit objectives may vary widely and include assessments of the following, EXCEPT for

    a. Program effectiveness, economy, and efficiency.
    b. Internal controls.
    c. Compliance.
    d. Review of confidential client information.

Nonaudit Services Provided by Audit Organizations

What about Services Not Covered by GAGAS?

GAGAS does not cover *nonaudit services*, which are defined as professional services other than audits or attestation engagements. Therefore, auditors do not report that the nonaudit services were conducted in accordance with GAGAS. When performing nonaudit services for an entity for which the audit organization performs a GAGAS audit or attestation engagement, audit organizations should communicate with requestors and those charged with governance to clarify that the work performed does not constitute an audit, attestation engagement, or audit procedures under GAGAS.

Audit organizations that provide nonaudit services to entities they audit should assess the impact that providing those services may have on auditor independence and respond to any identified threats to independence in accordance with the GAGAS independence standard.

Use of Terminology to Define GAGAS Requirements

GAGAS contain requirements together with related guidance in the form of explanatory material. Auditors have a responsibility to consider the entire text of GAGAS in carrying out their work and in understanding and applying the requirements in GAGAS. Not every paragraph of GAGAS carries a requirement that auditors and audit organizations are expected to fulfill. Rather, the requirements are identified through use of specific language. The terminology in GAGAS is consistent with the terminology as defined in GAAS.

GAGAS Use Two Categories of Requirements, Identified by Specific Terms, to Describe the Degree of Responsibility They Impose on Auditors and Audit Organizations, as Follows:
Unconditional Requirements Auditors and audit organizations are required to comply with an unconditional requirement in all cases in which the circumstances exist to which the unconditional requirement applies. GAGAS use the words *must* or *is required* to specify an unconditional requirement.
Presumptively Mandatory Requirements Auditors and audit organizations are also required to comply with a presumptively mandatory requirement in all cases in which the circumstances exist to which the presumptively mandatory requirement applies; however, in rare circumstances, auditors and audit organizations may depart from a presumptively mandatory requirement provided they document their justification for the departure and how the alternative procedures performed in the circumstances were sufficient to achieve the objectives of the presumptively mandatory requirement. GAGAS use the word *should* to specify a presumptively mandatory requirement.

Additional considerations and guidance within GAGAS (including appendix I to the Yellow Book) are intended to be descriptive rather than required as defined in the illustration above. The words *may*, *might*, and *could* are used to provide additional considerations and guidance on the requirements or to identify and describe other procedures or actions relating to auditor's or audit organization's activities.

Relationship between GAGAS and Other Professional Requirements

As noted previously, for financial audits and attestation engagements, GAGAS incorporates AICPA standards by reference. In addition, GAGAS may be used in conjunction with professional standards issued by other authoritative bodies such as the following:

- International Auditing and Assurance Standards Board (IAASB)
- Public Company Accounting Oversight Board (PCAOB)

Stating Compliance with GAGAS in the Auditors' Report

When auditors are required to perform an audit or attestation engagement in accordance with GAGAS or are representing to others that they did so, they should cite compliance with GAGAS in the auditors' report as discussed in the following section.

Citing Compliance With GAGAS in the Auditors' Report	
Per GAGAS Paragraph 2.24	Auditors should include one of the following types of GAGAS compliance statements in reports on GAGAS audits and attestation engagements, as appropriate. **Unmodified GAGAS Compliance Statement** Stating that the auditor performed the audit or attestation engagement in accordance with GAGAS. Auditors should include an unmodified GAGAS compliance statement in the audit report when they have (1) followed unconditional and applicable presumptively mandatory GAGAS requirements, or (2) have followed unconditional requirements, and documented justification for any departures from applicable presumptively mandatory requirements and have achieved the objectives of those requirements through other means. **Modified GAGAS Compliance Statement** Stating either that 1. The auditor performed the audit or attestation engagement in accordance with GAGAS, except for specific applicable requirements that were not followed; or 2. Because of the significance of the departure(s) from the requirements, the auditor was unable to and did not perform the audit or attestation engagement in accordance with GAGAS. Situations when auditors use modified compliance statements include scope limitations, such as restrictions on access to records, government officials, or other individuals needed to conduct the audit. When auditors use a modified GAGAS statement, they should disclose in the report the applicable requirement(s) not followed, the reasons for not following the requirement(s), and how not following the requirement(s) affected, or could have affected, the audit and the assurance provided.
Per GAGAS Paragraph 2.25	When auditors do not comply with applicable requirement(s), they should (1) assess the significance of the noncompliance to the audit objectives; (2) document the assessment, along with their reasons for not following the requirement(s); and (3) determine the type of GAGAS compliance statement. The auditors' determination is a matter of professional judgment, which is affected by the significance of the requirement(s) not followed in relation to the audit objectives.

Other Important Concepts

Relationship of Government Auditing Standards to the Uniform Guidance

Audits required by the Single Audit Act Amendments of 1996 as performed under Title 2 U.S. *Code of Federal Regulations* Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance) require the use of Government Auditing Standards. The following illustrates the relationship among all these standards.

Uniform Guidance / Government Auditing Standards Relationship

Uniform Guidance compliance audits involve three layers of requirements:

- Uniform Guidance requirements
- GAGAS requirements
- GAAS requirements

AICPA Ethics Consideration

AICPA Ethics Interpretation, *Governmental Audits* (ET section 1.400.055)

Engagements for audits of government grants, government units, or other recipients of government monies typically require that such audits be in compliance with government audit standards, guides, procedures, statutes, rules, and regulations, *in addition to* GAAS. If a member has accepted such an engagement and undertakes an obligation to follow specified government audit standards, guides, procedures, statutes, rules and regulations, the member is obligated to follow such requirements, in addition to GAAS. Failure to do so is an act discreditable to the profession in violation of the "Acts Discreditable Rule" (ET section 1.400.001), unless the member discloses in his or her report the fact that such requirements were not followed and the reasons for not following the requirements.

Key Foundational Points

1. The Yellow Book describes the types of audits and attestation engagements that audit organizations may perform under GAGAS.
2. The Yellow Book provides terminology to define professional requirements.
3. Auditors may use GAGAS in conjunction with professional standards issued by other authoritative bodies.
4. When auditors are required to perform an audit or attestation engagement in accordance with GAGAS or are representing to others that they did so, they should cite compliance with GAGAS in the auditors' report.

Chapter 3

General Standards

Learning Objectives

After completing this chapter, you should be able to do the following:

- Identify the four general standards found in generally accepted government auditing standards (GAGAS or the Yellow Book).
- Identify the four interrelated sections related to the consideration of independence in GAGAS.
- Recognize the importance of professional judgment.
- Identify what the Yellow Book competence standard encompasses.
- Identify the Yellow Book quality control and assurance requirements.

Introduction

Chapter 3 of the Yellow Book establishes general standards and provides guidance for performing financial audits, attestation engagements, and performance audits under GAGAS. These general standards, along with the overarching ethical principles presented in chapter 1 of the Yellow Book, establish a foundation for credibility of auditors' work. The four general standards are

- independence;
- professional judgment;
- competence; and
- quality control and assurance.

Independence

In all matters relating to audit work, the audit organization and the individual auditor, whether government or public, must be independent.

As illustrated in the following section, the Yellow Book notes that independence includes *independence of mind* and *independence in appearance*.

Independence of mind is the state of mind that permits the performance of an audit without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and to exercise objectivity and professional skepticism.

Independence in appearance is the absence of circumstances that would cause a reasonable and informed third party, having knowledge of the relevant information, to reasonably conclude that the integrity, objectivity, or professional skepticism of an audit organization or member of the audit team has been compromised.

Auditors and audit organizations maintain independence so that their opinions, findings, conclusions, judgments, and recommendations will be impartial and viewed as impartial by reasonable and informed third parties. Auditors should avoid situations that could lead reasonable and informed third parties to conclude that the auditors are not independent and thus are not capable of exercising objective and impartial judgment on all issues associated with conducting the audit and reporting on the work.

When Should the Auditor Be Independent?

Except under limited circumstances (described in paragraphs 3.47 and 3.48 of the Yellow Book), auditors should be independent from an audited entity during

- any period of time that falls within the period covered by the financial statements or subject matter of the audit; and
- the period of the professional engagement, which begins when the auditor either signs an initial engagement letter or other agreement to perform an audit or begins to perform an audit, whichever is earlier.

The period lasts for the entire duration of the professional relationship which could cover many periods in the case of recurring audits. The period ends with the formal or informal notification, either by the auditor or the audited entity, of the termination of the professional relationship. Accordingly, the period does not necessarily end with the issuance of the report and recommence with the beginning of the following year's audit or a subsequent audit with a similar objective.

GAGAS's Practical Consideration of Independence Consists of Four Interrelated Sections	
1	A conceptual framework for making independence determinations based on facts and circumstances that are often unique to specific environments
2	Requirements for and guidance on independence for audit organizations that are structurally located within the entities they audit
3	Requirements for and guidance on independence for auditors performing nonaudit services, including indication of specific nonaudit services that always impair independence and others that would not normally impair independence
4	Requirements for and guidance on documentation necessary to support adequate consideration of auditor independence

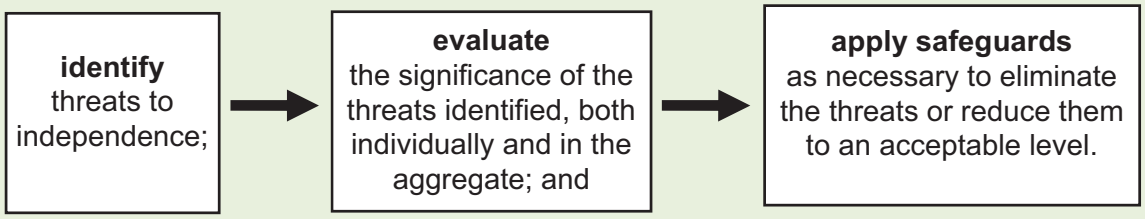
GAGAS Conceptual Framework Approach to Independence

Many different circumstances, or combinations of circumstances, are relevant in evaluating threats to independence. Therefore, GAGAS establishes a conceptual framework that auditors use to identify, evaluate, and apply safeguards to address threats to independence.

The conceptual framework assists auditors in maintaining both independence of mind and independence in appearance. It can be applied to many variations in circumstances that create threats to independence and allows auditors to address threats to independence that result from activities that are not specifically prohibited by GAGAS. Appendix II of the 2011 Yellow Book includes a flowchart to assist auditors in the application of the conceptual framework for independence.

Question: Why should auditors apply the conceptual framework?

Answer: Auditors should apply the conceptual framework at the audit organization, engagement and individual auditor level to



If safeguards cannot be implemented to eliminate or reduce a threat to an acceptable level, then independence is considered to be impaired.

The Identification and Evaluation of Threats to Independence

Threats to independence are circumstances that could impair independence. Whether independence is impaired depends on the nature of the threat, whether the threat is of such significance that it would compromise an auditor's professional judgment or create the appearance that the auditor's professional judgment may be compromised, and the specific safeguards applied to eliminate the threat or reduce it to an acceptable level. Threats are conditions that need to be evaluated using the conceptual framework. Threats do not necessarily impair independence.

Threats to independence may be created by a wide range of relationships and circumstances.

At a Minimum, Auditors Should Evaluate the Following Broad Categories of Threats to Independence When Threats Are Identified:	
Self-Interest Threat	The threat that a financial or other interest will inappropriately influence an auditor's judgment or behavior
Self-Review Threat	The threat that an auditor or audit organization that has provided nonaudit services will not appropriately evaluate the results of previous judgments made or services performed as part of the nonaudit services when forming a judgment significant to an audit
Bias Threat	The threat that an auditor will, as a result of political, ideological, social, or other convictions, take a position that is not objective
Familiarity Threat	The threat that aspects of a relationship with management or personnel of an audited entity, such as a close or long relationship, or that of an immediate or close family member, will lead an auditor to take a position that is not objective
Undue Influence Threat	The threat that external influences or pressures will impact an auditor's ability to make independent and objective judgments
Management Participation Threat	The threat that results from an auditor taking on the role of management or otherwise performing management functions on behalf of the entity undergoing an audit
Structural Threat	The threat that an audit organization's placement within a government entity, in combination with the structure of the government entity being audited, will impact the audit organization's ability to perform work and report results objectively

Circumstances that result in a threat to independence in one of the above categories may result in other threats as well. For example, a circumstance resulting in a structural threat to independence may also expose auditors to undue influence and management participation threats.

Applying Safeguards to Eliminate or Reduce Threats

The goal of applying safeguards is to reduce or eliminate threats to independence or reduce those threats to an acceptable level. As stated previously, if this cannot be accomplished, independence is considered impaired.

Safeguards are controls designed to eliminate threats to independence or reduce them to an acceptable level. Under the conceptual framework, the auditor applies safeguards that address the specific facts and circumstances under which threats to independence exist. Multiple safeguards may be necessary to address a threat. Chapter 3 of the Yellow Book provides a list of example safeguards that may be effective under certain circumstances. The list cannot provide safeguards for all circumstances. It may, however, provide a starting point for auditors who have identified threats to independence and are considering what safeguards could eliminate those threats or reduce them to an acceptable level.

The following lists the examples of safeguards from chapter 3 of the Yellow Book.

Examples of Safeguards	
1	Consulting an independent third party, such as a professional organization, a professional regulatory body or another auditor
2	Involving another audit organization to perform or reperform part of the audit
3	Having a professional staff member who was not involved with a nonaudit service review any nonaudit work performed
4	Removing an individual from an audit team when that individual's financial or other interests or relationships pose a threat to independence

Depending on the nature of the audit, an auditor may also be able to place limited reliance on safeguards that the audited entity has implemented. It is not possible to rely solely on such safeguards to reduce threats to an acceptable level.

Examples of Safeguards Within the Audited Entity's Systems and Procedures	
1	An entity requirement that persons other than management ratify or approve the appointment of an audit organization to perform an audit
2	Internal procedures at the audited entity that ensure objective choices in commissioning nonaudit services
3	A governance structure at the audited entity that provides appropriate oversight and communications regarding the audit organization's services

Application of the Conceptual Framework

Auditors should evaluate threats to independence using the conceptual framework when the facts and circumstances under which the auditors perform their work create or augment threats to independence. Auditors should evaluate threats both individually and in the aggregate because threats can have a cumulative effect on an auditor's independence.

Facts and circumstances that create threats to independence can result from events such as the start of a new audit; assigning new staff to an ongoing audit; and acceptance of a nonaudit service at an audited entity. Many other events can result in threats to independence and auditors use professional judgment to determine whether the facts and circumstances created by an event warrant use of the conceptual framework.

Whenever relevant new information about a threat to independence comes to the attention of the auditor during the audit, the auditor should evaluate the significance of the threat in accordance with the conceptual framework.

Auditors should determine whether identified threats to independence are at an acceptable level or have been eliminated or reduced to an acceptable level. The components of independence discussed earlier (independence of mind and independence in appearance) are central to this determination.

Certain Types of Threats to Independence Are Unacceptable. A Threat to Independence Is Not Acceptable If It Either

- could impact the auditor's ability to perform an audit without being affected by influences that compromise professional judgment; or
- could expose the auditor or audit organization to circumstances that would cause a reasonable and informed third party to conclude that the integrity, objectivity, or professional skepticism of the audit organization, or a member of the audit team, has been compromised.

When an auditor identifies threats to independence and, based on an evaluation of those threats, determines that they are not at an acceptable level, the auditor should determine whether appropriate safeguards are available and can be applied to eliminate the threats or reduce them to an acceptable level.

The auditor should exercise professional judgment in making that determination, and should take into account whether both independence of mind and independence in appearance are maintained. The auditor should evaluate both qualitative and quantitative factors when determining the significance of a threat. In cases where threats to independence are not at an acceptable level, thereby requiring the application of safeguards, the auditor should document the threats identified and the safeguards applied to eliminate the threats or reduce them to an acceptable level.

When conditions lead to threats that are so significant that they cannot be eliminated or reduced to an acceptable level through the application of safeguards, resulting in impaired independence, the auditor should decline to perform a prospective audit or terminate an audit in progress.

If a threat to independence is initially identified after the audit report is issued, the auditor should immediately evaluate the threat's impact on the audit and on GAGAS compliance. If the auditor determines that the newly identified threat had an impact on the audit which would have resulted in the audit report being different from the report issued had the auditor been aware of it, the auditor should communicate in the same manner as that used to originally distribute the report to those charged with governance, the appropriate officials of the audited entity, the appropriate officials of the organizations requiring or arranging for the audits, and other known users, so that they do not continue to rely on findings or conclusions that were impacted by the threat to independence. If the report was previously posted to the auditor's publicly accessible website, the auditor should remove the report and post a public notification that the report was removed. The auditor should then determine whether to conduct additional audit work necessary to reissue the report, including a revised findings or conclusions or repost the original report if the additional audit work does not result in a change in findings or conclusions.

When Do I Use the Conceptual Framework?

Both Government Auditing Standards and the AICPA Code of Professional Conduct contain conceptual frameworks for independence with similar characteristics. Under Government Auditing Standards, the conceptual framework is used to evaluate threats to independence when making decisions on conditions or activities that are not specifically prohibited by Government Auditing Standards. The AICPA conceptual framework should be used when making decisions on independence matters that are not explicitly addressed by the Code of Professional Conduct. Consequently, the Government Auditing Standards conceptual framework will be used more often than the AICPA conceptual framework.

Knowledge Check

1. Under the Yellow Book, all of the following examples of safeguards help eliminate threats to auditor independence, EXCEPT for

    a. Consulting an independent third party, such as a professional organization, a professional regulatory body or another auditor.
    b. Involving another audit organization to perform or reperform part of the audit.
    c. Having a professional staff member who was not involved with a nonaudit service review any nonaudit work performed.
    d. Retaining an individual on an audit team when that individual's financial or other interests or relationships pose a threat to independence.

Government Auditors and Audit Organizational Structure

The ability of audit organizations in government entities to perform work and report the results objectively can be affected by placement within government, and the structure of the government entity being audited. Whether reporting to third parties externally (external auditors) or to senior management within the audited entity (internal auditors), the independence standards in GAGAS apply to government auditors and audit organizations.

Governmental External Auditors

Audit organizations that are structurally located within government entities are often subject to constitutional or statutory safeguards that mitigate the effects of structural threats to independence. For external audit organizations, such safeguards may include governmental structures under which a government audit organization is

- at a level of government other than the one of which the audited entity is part (federal, state, or local); for example, federal auditors auditing a state government program; or
- placed within a different branch of government from that of the audited entity; for example, legislative auditors auditing an executive branch program.

Safeguards other than those described above may mitigate structural threats resulting from governmental structures. For external auditors, or auditors who report both externally and internally, structural threats may be mitigated if the head of an audit organization meets any of the following criteria in accordance with constitutional or statutory requirements:

- Directly elected by voters of the jurisdiction being audited
- Elected or appointed by a legislative body, subject to removal by a legislative body, and reports the results of audits to and is accountable to a legislative body
- Appointed by someone other than a legislative body, so long as the appointment is confirmed by a legislative body and removal from the position is subject to oversight or approval by a legislative body, and reports the results of audits to and is accountable to a legislative body
- Appointed by, accountable to, reports to, and can only be removed by a statutorily created governing body, the majority of whose members are independently elected or appointed and come from outside the organization being audited

In addition to these criteria, GAGAS recognize that there may be other organizational structures under which external audit organizations in government entities could be considered to be independent. If appropriately designed and implemented, these structures provide safeguards that prevent the audited entity from interfering with the audit organization's ability to perform the work and report the results impartially. For an external audit organization to be considered independent under a structure different from the ones discussed above, the audit organization should have all of the following safeguards. In such situations, the audit organization should document how each of the following safeguards was satisfied and provide the documentation to those performing quality control monitoring and to the external peer reviewers to determine whether all the necessary safeguards are in place:

- Statutory protections that prevent the audited entity from abolishing the audit organization
- Statutory protections that require that if the head of the audit organization is removed from office, the head of the agency reports this fact and the reasons for the removal to the legislative body
- Statutory protections that prevent the audited entity from interfering with the initiation, scope, timing, and completion of any audit

- Statutory protections that prevent the audited entity from interfering with audit reporting, including the findings and conclusions or the manner, means, or timing of the audit organization's reports
- Statutory protections that require the audit organization to report to a legislative body or other independent governing body on a recurring basis
- Statutory protections that give the audit organization sole authority over the selection, retention, advancement, and dismissal of its staff
- Statutory access to records and documents related to the agency, program, or function being audited and access to government officials or other individuals as needed to conduct the audit

Governmental Internal Auditors

Certain federal, state, or local government entities employ auditors to work for management of the audited entities. These auditors may be subject to administrative direction from persons involved in the entity management process. Such audit organizations are *internal audit* functions and are encouraged to use the Institute of Internal Auditors (IIA) *International Standards for the Professional Practice of Internal Auditing* in conjunction with GAGAS. Under GAGAS, internal auditors who work under the direction of the audited entity's management are considered independent if the head of the audit organization meets all of the following criteria:

- Is accountable to the head or deputy head of the government entity or to those charged with governance
- Reports the audit results both to the head or deputy head of the government entity and to those charged with governance
- Is located organizationally outside the staff or line-management function of the unit under audit
- Has access to those charged with governance
- Is sufficiently removed from political pressures to conduct audits and report findings, opinions, and conclusions objectively without fear of political reprisal

When internal audit organizations perform audits of external parties such as auditing contractors or outside party agreements, and no impairments to independence exist, the audit organization can be considered independent as an external audit organization of those external parties.

Providing Nonaudit Services to Audited Entities

Audit organizations have traditionally provided a range of nonaudit services that are consistent with their skills and expertise to entities at which they perform audits. Providing such nonaudit services may, however, create threats to an auditor's independence.

Requirements for Performing Nonaudit Services

Before an auditor agrees to provide a nonaudit service to an audited entity, the auditor should determine whether providing such a service would create a threat to independence*, either by itself or in aggregate with other nonaudit services provided*, with respect to any GAGAS audit it performs. *A critical component of this determination is consideration of management's ability to effectively oversee the nonaudit service to be performed.* The auditor should determine that the audited entity has designated an individual who possesses suitable skill, knowledge, or experience, and that the individual understands the services to be performed sufficiently to oversee them. The individual is not required to possess the expertise to perform or reperform the services. The auditor should document consideration of management's ability to effectively oversee nonaudit services to be performed.

If an auditor were to assume management responsibilities for an audited entity, the management participation threats created would be so significant that no safeguards could reduce them to an acceptable level. Management responsibilities involve leading and directing an entity, and include making significant decisions regarding the acquisition, deployment and control of human, financial, physical, and intangible resources.

Whether an activity is a management responsibility depends on the facts and circumstances and the auditor exercises professional judgment in identifying these activities. The Yellow Book provides the following examples of activities that would be considered a management responsibility and, therefore, impair independence if performed for an audited entity.

Examples of Activities That Would Be Considered a Management Responsibility and, Therefore, Impair Independence if Performed for an Audited Entity

- Setting policies and strategic direction for the audited entity
- Directing and accepting responsibility for the actions of the audited entity's employees in the performance of their routine recurring activities
- Having custody of an audited entity's assets
- Reporting to those charged with governance on behalf of management
- Deciding which of the auditor's or outside third party's recommendations to implement
- Accepting responsibility for the management of an audited entity's project
- Accepting responsibility for designing, implementing, or maintaining internal control
- Providing services that are intended to be used as management's primary basis for making decisions that are significant to the subject matter of the audit
- Developing an audited entity's performance measurement system when that system is material or significant to the subject matter of the audit
- Serving as a voting member of an audited entity's management committee or board of directors

Auditors performing nonaudit services for entities for which they perform audits should obtain assurance that audited entity management performs the following functions in connection with the nonaudit services:

- Assumes all management responsibilities
- Oversees the services by designating an individual, preferably within senior management, who possesses suitable skill, knowledge, and experience
- Evaluates the adequacy and results of the services performed
- Accepts responsibility for the results of the services

In cases where the audited entity is unable or unwilling to assume the responsibilities just listed (for example, the audited entity does not have an individual with suitable skill, knowledge, and experience to oversee the nonaudit services provided, or is unwilling to perform such functions due to lack of time or desire), the auditor's provision of these services would impair independence.

In connection with nonaudit services, *auditors should establish and document in writing their understanding with the audited entity's management or those charged with governance, as appropriate*, regarding the following:

- Objectives of the nonaudit service

- Services to be performed
- Audited entity's acceptance of its responsibilities
- Auditors' responsibilities
- Any limitations of the nonaudit service

Routine activities performed by auditors that relate directly to the performance of an audit, such as providing advice and responding to questions as part of an audit, are not considered nonaudit services under GAGAS. Such routine activities generally involve providing advice or assistance to the entity on an informal basis as part of an audit. Routine activities typically are insignificant in terms of time incurred or resources expended and generally do not result in a specific project or engagement or in the auditor producing a formal report or other formal work product.

Routine activities directly related to an audit include the following:

- Providing advice to the audited entity on an accounting matter as an ancillary part of the overall financial audit
- Researching and responding to the audited entity's technical questions on relevant tax laws as an ancillary part of providing tax services
- Providing advice to the audited entity on routine business matters
- Educating the audited entity on matters within the technical expertise of the auditor
- Providing information to the audited entity that is readily available to the auditor, such as best practices and benchmarking studies

Auditors who previously performed nonaudit services for an entity that is a prospective subject of an audit should evaluate the impact of those nonaudit services on independence before accepting an audit. If the nonaudit services were performed in the period to be covered by the audit, the auditor should (1) determine if the nonaudit service is expressly prohibited by GAGAS and, if not, (2) determine whether a threat to independence exists and address any threats noted in accordance with the framework.

Auditors may also need to consider the impact of nonaudit services they provide on independence of mind and in appearance in periods beyond the period in which they provided the nonaudit service. For example, if auditors have designed and implemented an accounting and financial reporting system that is expected to be in place for many years, a threat to independence in appearance for future financial audits or attestation engagements performed by those auditors may exist in subsequent periods.

For recurring audits, having another independent audit organization perform an audit of the areas affected by the nonaudit service may provide a safeguard that allows the audit organization that provided the nonaudit service to mitigate the threat to its independence. Auditors use professional judgment to determine whether the safeguards adequately mitigate the threats.

An auditor in a government entity may be required to perform a nonaudit service that could impair the auditor's independence with respect to a required audit. If the auditor cannot, as a consequence of constitutional or statutory requirements over which the auditor has no control, implement safeguards to reduce the resulting threat to an acceptable level, or decline to perform or terminate a nonaudit service that is incompatible with audit responsibilities, the auditor should disclose the nature of the threat that could not be eliminated or reduced to an acceptable level and modify the GAGAS compliance statement accordingly.

Knowledge Check

2. Activities that would be considered a management responsibility, and therefore would impair independence, include all of the following, EXCEPT

    a. Deciding which recommendations of the auditor or outside third party to implement.
    b. Providing advice to the audited entity on routine business matters.
    c. Having custody of the audited entity assets.
    d. Setting policies and strategic direction for the audited entity.

Consideration of Specific Nonaudit Services

By their nature, certain nonaudit services directly support the entity's operations and impair auditors' ability to maintain independence in mind and appearance. The Yellow Book identifies the nonaudit services mentioned in this section as being among those frequently requested of auditors working in a government environment. Some aspects of these services will impair an auditor's ability to audit the entities for which the services are provided. The specific services indicated are not the only nonaudit services that would impair an auditor's independence.

Auditors may be able to provide nonaudit services in the broad areas indicated below without impairing independence *if* the nonaudit services are not expressly prohibited, the auditor has determined that the requirements for performing nonaudit services have been met, and any significant threats to independence have been eliminated or reduced to an acceptable level through the application of safeguards. Auditors should use the conceptual framework to evaluate independence given the facts and circumstances of individual services not specifically prohibited in this section.

For performance audits and agreed-upon procedures engagements, nonaudit services that are otherwise prohibited by GAGAS may be provided when such services do not relate to the specific subject matter of the engagement.

For financial statement audits and examination or review engagements, a nonaudit service performed during the period covered by the financial statements may not impair an auditor's independence with respect to those financial statements provided that the following conditions exist:

- The nonaudit service was provided prior to the period of professional engagement.
- The nonaudit service related only to periods prior to the period covered by the financial statements.
- The financial statements for the period to which the nonaudit service did relate were audited by another auditor (or in the case of an examination or review engagement, examined, reviewed, or audited by another auditor as appropriate).

Examples of Nonaudit Services	
Preparing Accounting Records and Financial Statements	Some services involving preparation of accounting records always impair an auditor's independence with respect to an audited entity. These services include ▪ determining or changing journal entries, account codes or classifications for transactions, or other accounting records for an entity without obtaining the entity's approval; ▪ authorizing or approving transactions; and ▪ preparing or making changes to source documents without management approval (for example, purchase orders, payroll time records, customer orders, and contracts). Such records also include an entity's general ledger and subsidiary records or equivalent. Management is responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework, even if the auditor assisted in drafting those financial statements. Consequently, an auditor's acceptance of responsibility for the preparation and fair presentation of financial statements that the auditor will subsequently audit would impair the auditor's independence. Services related to preparing accounting records and financial statements that an auditor may be able to provide to an audited entity if the conditions previously discussed are met include ▪ recording transactions for which management has determined or approved the appropriate account classification, or posting coded transactions to an audited entity's general ledger; ▪ preparing financial statements based on information in the trial balance; ▪ posting entries that have been approved by an audited entity's management to the entity's trial balance; ▪ preparing account reconciliations that identify reconciling items for the audited entity management's evaluation; and ▪ proposing standard, adjusting, or correcting journal entries or other changes affecting the financial statements to an audited entity's management provided management reviews and accepts the entries and the auditor is satisfied that management understands the nature of the proposed entries and the impact the entries have on the financial statements.

Examples of Nonaudit Services (continued)	
Internal Audit Assistance Services Provided by External Auditors	Internal audit services involve assisting an entity in the performance of its internal audit activities. Certain internal audit assistance activities always impair an external auditor's independence with respect to an audited entity. These activities include ▪ setting internal audit policies or the strategic direction of internal audit activities; ▪ performing procedures that form part of the internal control, such as reviewing and approving changes to employee data access privileges; and ▪ determining the scope of the internal audit function and resulting work.
Internal Control Monitoring as a Nonaudit Service	Accepting responsibility for designing, implementing, or maintaining internal control includes accepting responsibility for designing, implementing, or maintaining monitoring procedures. Monitoring involves the use of either ongoing monitoring procedures or separate evaluations to gather and analyze persuasive information supporting conclusions about the effectiveness of the internal control system. Ongoing monitoring procedures performed on behalf of management are built into the routine, recurring operating activities of an organization. Therefore, the management participation threat created if an auditor performs or supervises ongoing monitoring procedures is so significant that no safeguards could reduce the threat to an acceptable level. Separate evaluations are sometimes performed as nonaudit services by individuals who are not directly involved in the operation of the controls being monitored. As such, it is possible for an auditor to provide an objective analysis of control effectiveness by performing separate evaluations without creating a management participation threat that would impair independence. However, in all such cases, the significance of the threat created by performing separate evaluations should be evaluated and safeguards applied when necessary to eliminate the threat or reduce it to an acceptable level. Auditors should assess the frequency of the separate evaluations as well as the scope or extent of the controls (in relation to the scope of the audit performed) being tested in evaluating the significance of the threat. An evaluation prepared as a nonaudit service is not a substitute for audit procedures in a GAGAS audit.

Examples of Nonaudit Services (continued)	
Information Technology Systems Services	Services related to information technology (IT) systems include the design or implementation of hardware or software systems. The systems may aggregate source data, form part of the internal control over the subject matter of the audit, or generate information that affects the subject matter of the audit. IT services that would impair independence if provided by an audit organization to an audited entity include ▪ design or development of a financial or other IT system that would play a significant role in the management of an area of operations that is or will be an audit's subject matter; ▪ services that entail making other than insignificant modifications to the source code underlying such a system; and ▪ operating or supervising the operation of such a system.
Valuation Services	A valuation comprises the making of assumptions with regard to future developments, the application of appropriate methodologies and techniques, and the combination of both to compute a certain value, or range of values, for an asset, a liability, or a business as a whole. If an audit organization provides valuation services to an audited entity and the valuations would have a material effect, separately or in the aggregate, on the financial statements or other information on which it is reporting, and the valuation involves a significant degree of subjectivity, the audit organization's independence would be impaired.
Other Nonaudit Services	Provision of certain other nonaudit services always impairs an external auditor's independence with respect to an audited entity. These activities include the following: ▪ *Nontax disbursement* – Prohibited nonaudit services include ○ accepting responsibility to authorize payment of audited entity funds, electronically or otherwise; ○ accepting responsibility for signing or cosigning audited entity checks, even if only in emergency situations; ○ maintaining an audited entity's bank account or otherwise having custody of an audited entity's funds or making credit or banking decisions for the audited entity; and ○ approving vendor invoices for payment.

Examples of Nonaudit Services (continued)	
	▪ *Benefit plan administration* – Prohibited nonaudit services include ○ making policy decisions on behalf of audited entity management; ○ when dealing with plan participants, interpreting the plan document on behalf of management without first obtaining management's concurrence; ○ making disbursements on behalf of the plan; ○ having custody of a plan's assets; and ○ serving a plan as fiduciary as defined by the Employee Retirement Income Security Act (ERISA). ▪ *Investment-advisory or management* – Prohibited nonaudit services include ○ making investment decisions on behalf of audited entity management or otherwise having discretionary authority over an audited entity's investments; ○ executing a transaction to buy or sell an audited entity's investment; and ○ having custody of an audited entity's assets, such as taking temporary possession of securities purchased by an audited entity. ▪ *Corporate finance: consulting or advisory* – Prohibited nonaudit services include ○ committing the audited entity to the terms of a transaction or consummating a transaction on behalf of the audited entity; ○ acting as a promoter, underwriter, broker-dealer, or guarantor of audited entity securities, or distributor of private placement memoranda or offering documents; and ○ maintaining custody of an audited entity's securities. ▪ *Executive or employee personnel matters* – Prohibited nonaudit services include ○ committing the audited entity to employee compensation or benefit arrangements; and ○ hiring or terminating audited entity employees.

Examples of Nonaudit Services (continued)	
	▪ *Business risk consulting* – Prohibited nonaudit services include ○ making or approving business risk decisions; and ▪ presenting business risk considerations to those charged with governance or others on behalf of management.

Documentation of Independence Considerations

Documentation of considerations regarding independence provides evidence of the auditor's judgments in forming conclusions regarding compliance with independence requirements. GAGAS contains specific requirements for documentation related to independence, which may be in addition to the documentation that auditors have previously maintained. While insufficient documentation of an auditor's compliance with the independence standards does not impair independence, appropriate documentation is required under GAGAS quality control and assurance requirements.

The independence standard includes the following documentation requirements:

- Document threats to independence that required the application of safeguards, along with safeguards applied, in accordance with the conceptual framework for independence.
- Document the safeguards required if an audit organization is structurally located within a government entity and is considered independent based on those safeguards.
- Document consideration of audited entity management's ability to effectively oversee a nonaudit service to be provided by the auditor.
- Document the auditor's understanding with an audited entity for which the auditor will perform a nonaudit service.

Knowledge Check

3. GAGAS contains requirements regarding the documentation of independence considerations. Which of the following is NOT one of the documentation requirements?

    a. Document threats to independence that require the application of safeguards, along with the safeguards applied.
    b. Document the safeguards required by GAGAS if an audit organization is structurally located within a government entity and is considered independent based on those safeguards.
    c. Document the consideration of the audited entity management's ability to effectively oversee a nonaudit service only when management refuses to place such a statement in the management representation letter.
    d. Document the auditor's understanding with an audited entity for which the auditor will perform a nonaudit service.

Professional Judgment

Auditors must use professional judgment in planning and performing audits and in reporting the results.

Professional judgment includes exercising reasonable care and professional skepticism. Reasonable care includes acting diligently in accordance with applicable professional standards and ethical principles. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of evidence. Professional skepticism includes a mindset in which auditors assume neither that management is dishonest, nor of unquestioned honesty.

Using the auditor's professional knowledge, skills, and experience to diligently perform, in good faith and with integrity, the gathering of information and the objective evaluation of the sufficiency and appropriateness of evidence is a critical component of audits. Professional judgment and competence are interrelated because judgments made are dependent upon the auditor's competence.

A Collaborative Effort

Professional judgment represents the application of the collective knowledge, skills, and experiences of all the personnel involved with an audit, as well as the professional judgment of individual auditors. In addition to personnel directly involved in the audit, professional judgment may involve collaboration with other stakeholders, external specialists, and management in the audit organization.

Using professional judgment is important to auditors in carrying out all aspects of their professional responsibilities, including following the independence standards and related conceptual framework, maintaining objectivity and credibility, assigning competent audit staff to the assignment, defining the scope of work, evaluating, documenting, and reporting the results of the work, and maintaining appropriate quality control over the audit process.

Using professional judgment is important to auditors in applying the conceptual framework to the determination of auditor independence in a given situation. This includes the consideration of any threats to the auditor's independence and related safeguards, which may mitigate the identified threats. Auditors use professional judgment in identifying and evaluating any threats to independence, including threats to the appearance of independence.

Using professional judgment is important to auditors in determining the required level of understanding of the audit subject matter and related circumstances. This includes consideration about whether the audit team's collective experience, training, knowledge, skills, abilities, and overall understanding are sufficient to assess the risks that the subject matter under audit may contain a significant inaccuracy or could be misinterpreted.

An auditor's consideration of the risk level of each assignment, including the risk of arriving at improper conclusions, is also important. Within the context of audit risk, exercising professional judgment in determining the sufficiency and appropriateness of evidence to be used to support the findings and conclusions based on the audit objectives and any recommendations reported is an integral part of the audit process.

Absolute Assurance Is Not Attainable

While this standard places responsibility on each auditor and audit organization to exercise professional judgment in planning and performing an audit, it does not imply unlimited responsibility, nor does it imply infallibility on the part of either the individual auditor or the audit organization. Absolute assurance is not attainable due to factors such as the nature of evidence and characteristics of fraud. Professional judgment does not mean eliminating all possible limitations or weaknesses associated with a specific audit, but rather identifying, considering, minimizing, mitigating, and explaining them.

Competence

The staff assigned to perform the audit must collectively possess adequate professional competence needed to address the audit objectives and perform the work in accordance with GAGAS.

The audit organization's management should assess skill needs to consider whether its workforce has the essential skills that match those necessary to perform the particular audit. Accordingly, audit organizations should have a process for recruitment, hiring, continuous development, assignment, and evaluation of staff to maintain a competent workforce. The nature, extent, and formality of the process will depend on various factors such as the size of the audit organization, its structure, and its work.

Competence is derived from a blending of education and experience. Competencies are not necessarily measured by years of auditing experience because such a quantitative measurement may not accurately reflect the kinds of experiences gained by an auditor in any given time period. Maintaining competence through a commitment to learning and development throughout an auditor's professional life is an important element for auditors. Competence enables an auditor to make sound professional judgments.

Technical Knowledge

The staff assigned to conduct an audit under GAGAS should collectively possess the technical knowledge, skills, and experience necessary to be competent for the type of work being performed before beginning work on that audit.

The staff assigned to a GAGAS audit should collectively possess

- knowledge of GAGAS applicable to the type of work they are assigned and the education, skills, and experience to apply this knowledge to the work being performed;
- general knowledge of the environment in which the audited entity operates and the subject matter;
- skills to communicate clearly and effectively, both orally and in writing; and
- skills appropriate for the work being performed.

In the prior list, we discuss that the staff assigned to a GAGAS audit should collectively possess skills appropriate for the work being performed. In discussing skills appropriate for the work being performed, the Yellow Book provides the following examples of skills:

- Statistical or nonstatistical sampling if the work involves use of sampling
- Information technology if the work involves review of information systems
- Engineering if the work involves review of complex engineering data
- Specialized audit methodologies or analytical techniques, such as the use of complex survey instruments, actuarial-based estimates, or statistical analysis tests, as applicable
- Specialized knowledge in subject matters, such as scientific, medical, environmental, educational, or any other specialized subject matter, if the work calls for such expertise

Additional Qualifications for Financial Audits and Attestation Engagements

Auditors performing financial audits should be knowledgeable in accounting principles generally accepted in the United States of America, or with the applicable financial reporting framework being used, and the AICPA Auditing Standards, and they should be competent in applying these standards to the audit work.

Similarly, auditors performing attestation engagements should be knowledgeable in the AICPA general attestation standard related to criteria, the AICPA attestation standards for fieldwork and reporting, and they should be competent in applying these standards to the attestation work.

Auditors engaged to perform financial audits or attestation engagements should be licensed certified public accountants, persons working for a licensed certified public accounting firm or for a government auditing organization, or licensed accountants in states that have multiclass licensing systems that recognize licensed accountants other than certified public accountants.

Continuing Professional Education

Auditors performing work under GAGAS, including planning, directing, performing audit procedures, or reporting on an audit conducted in accordance with GAGAS, should maintain their professional competence through continuing professional education (CPE).

The Yellow Book CPE Requirements Include the Following:

- Each auditor performing work under GAGAS should complete, every 2 years, at least 24 hours of CPE that directly relates to government auditing, the government environment, or the specific or unique environment in which the audited entity operates.
- Auditors who are involved in any amount of planning, directing, or reporting on GAGAS audits and auditors who are not involved in those activities but charge 20 percent or more of their time annually to GAGAS audits should also obtain at least an additional 56 hours of CPE (for a total of 80 hours of CPE in every 2-year period) that enhances the auditor's professional proficiency to perform audits.
- Auditors required to take the total 80 hours of CPE should complete at least 20 hours of CPE in each year of the 2-year periods.
- Auditors hired or initially assigned to GAGAS audits after the beginning of an audit organization's two-year CPE period should complete a prorated number of CPE hours.

CPE programs are structured educational activities with learning objectives designed to maintain or enhance participants' knowledge, skills, and abilities in areas applicable to performing audits. Determining what subjects are appropriate for individual auditors to satisfy both the 80-hour and the 24-hour requirements is a matter of professional judgment to be exercised by auditors in consultation with appropriate officials in their audit organizations. Among the considerations in exercising that judgment are the auditor's experience, the responsibilities they assume in performing GAGAS audits, and the operating environment of the audited entity.

Meeting CPE requirements is primarily the responsibility of individual auditors. The audit organization should have quality control procedures to help ensure that auditors meet the continuing education requirements, including documentation of the CPE completed.

The GAO has developed guidance pertaining to CPE requirements to assist auditors and audit organizations in exercising professional judgment in complying with the CPE requirements. This guidance may be found at www.gao.gov/yellowbook.

The audit team should determine that external specialists assisting in performing a GAGAS audit are qualified and competent in their areas of specialization. However, external specialists are not required to meet the GAGAS CPE requirements.

The audit team should determine that internal specialists consulting on a GAGAS audit who are not involved in directing, performing audit procedures, or reporting on a GAGAS audit, are qualified and competent in their areas of specialization. These internal specialists are not required to meet the GAGAS CPE requirements.

However, for those internal specialists who are performing work in accordance with GAGAS as part of the audit team, including directing, performing audit procedures, or reporting on a GAGAS audit, the audit team should determine that these internal specialists comply with GAGAS, including the CPE requirements. The GAGAS CPE requirements become effective for internal specialists when an audit organization first assigns an internal specialist to an audit. Since internal specialists apply specialized knowledge in government audits, training in their areas of specialization qualify under the requirement for 24 hours of CPE that directly relates to government auditing, the government environment, or the specific or unique environment in which the audited entity operates.

Knowledge Check

4. Auditors performing work under GAGAS, including planning, directing, performing audit procedures, or reporting on an audit conducted in accordance with GAGAS, should maintain their professional competence through CPE. Which of the following CPE requirements is NOT required by GAGAS?

    a. Each auditor performing work under GAGAS should complete, every 2 years, at least 24 hours of CPE that directly relates to government auditing, the government environment, or the specific or unique environment in which the audited entity operates.
    b. Auditors who are involved in any amount of planning, directing, or reporting on GAGAS audits and auditors who are not involved in those activities but who charge 20 percent or more of their time annually to GAGAS audits should also obtain at least an additional 56 hours of CPE (for a total of 80 hours of CPE in every 2-year period) that enhances the auditor's professional proficiency to perform audits.
    c. Auditors required to take the total 80 hours of CPE should complete at least 30 hours of CPE in each year of the 2-year period.
    d. Auditors hired or initially assigned to GAGAS audits after the beginning of an audit organization's two-year CPE period should complete a prorated number of CPE hours.

Quality Control and Assurance

Each audit organization performing audits in accordance with GAGAS must

- establish and maintain a system of quality control that is designed to provide the audit organization with reasonable assurance that the organization and its personnel comply with professional standards and applicable legal and regulatory requirements; and
- have an external peer review performed by reviewers independent of the audit organization being reviewed at least once every three years.

System of Quality Control

An audit organization's system of quality control encompasses the audit organization's leadership, emphasis on performing high quality work, and the organization's policies and procedures designed to provide reasonable assurance of complying with professional standards and applicable legal and regulatory requirements.

The nature, extent, and formality of an audit organization's quality control system will vary based on the audit organization's circumstances, such as the audit organization's size, number of offices, and geographic dispersion; the knowledge and experience of its personnel; the nature and complexity of its audit work; and cost-benefit considerations.

Documentation of the System of Quality Control

Each audit organization should document its quality control policies and procedures and communicate those policies and procedures to its personnel.

The audit organization should document compliance with its quality control policies and procedures and maintain such documentation for a period of time sufficient to enable those performing monitoring procedures and peer reviews to evaluate the extent of the audit organization's compliance with its quality control policies and procedures.

The form and content of such documentation are a matter of professional judgment and will vary based on the audit organization's circumstances.

An Audit Organization Should Establish Policies and Procedures in Its System of Quality Control That Collectively Address the Following:	
Leadership Responsibilities for Quality within the Audit Organization	Audit organizations should establish policies and procedures on leadership responsibilities for quality within the audit organization that include the designation of responsibility for quality of audits performed under GAGAS and communication of policies and procedures relating to quality. Appropriate policies and communications encourage a culture that recognizes that quality is essential in performing GAGAS audits and that leadership of the audit organization is ultimately responsible for the system of quality control. The audit organization should establish policies and procedures designed to provide it with reasonable assurance that those assigned operational responsibility for the audit organization's system of quality control have sufficient and appropriate experience and ability, and the necessary authority, to assume that responsibility.
Independence, Legal and Ethical Requirements	Audit organizations should establish policies and procedures on independence, legal, and ethical requirements that are designed to provide reasonable assurance that the audit organization and its personnel maintain independence, and comply with applicable legal and ethical requirements. Such policies and procedures assist the audit organization to ▪ communicate its independence requirements to its staff; and ▪ identify and evaluate circumstances and relationships that create threats to independence, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the audit where withdrawal is permitted by law or regulation.
Initiation, Acceptance and Continuance of Audits	Audit organizations should establish policies and procedures for the initiation, acceptance, and continuance of audits that are designed to provide reasonable assurance that the audit organization will undertake audits only if it can comply with legal requirements and ethical principles and is acting within the legal mandate or authority of the audit organization.
Human Resources	Audit organizations should establish policies and procedures for human resources that are designed to provide the audit organization with reasonable assurance that it has personnel with the capabilities and competence to perform its audits in accordance with professional standards and legal and regulatory requirements.

An Audit Organization Should Establish Policies and Procedures in Its System of Quality Control That Collectively Address the Following: (continued)	
Audit Performance, Documentation, and Reporting	Audit organizations should establish policies and procedures for audit performance, documentation, and reporting that are designed to provide the audit organization with reasonable assurance that audits are performed and reports are issued in accordance with professional standards and legal and regulatory requirements. When performing GAGAS audits, audit organizations should have policies and procedures for the safe custody and retention of audit documentation for a time sufficient to satisfy legal, regulatory, and administrative requirements for records retention. Whether audit or attest documentation is in paper, electronic, or other media, the integrity, accessibility, and retrievability of the underlying information could be compromised if the documentation is altered, added to, or deleted without the auditors' knowledge, or if the documentation is lost or damaged. For audit documentation that is retained electronically, the audit organization should establish effective information systems controls concerning accessing and updating the audit documentation.
Monitoring of Quality	Audit organizations should establish policies and procedures for monitoring of quality in the audit organization. Monitoring of quality is an ongoing, periodic assessment of work completed on audits designed to provide management of the audit organization with reasonable assurance that the policies and procedures related to the system of quality control are suitably designed and operating effectively in practice. The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of whether the ▪ professional standards and legal and regulatory requirements have been followed; ▪ quality control system has been appropriately designed; and ▪ quality control policies and procedures are operating effectively and complied with in practice. Monitoring procedures will vary based on the audit organization's facts and circumstances. The audit organization should perform monitoring procedures that enable it to assess compliance with applicable professional standards and quality control policies and procedures for GAGAS audits. Individuals performing monitoring should collectively have sufficient expertise and authority for this role. The audit organization should analyze and summarize the results of its monitoring process at least annually, with identification of any systemic or repetitive issues needing improvement, along with recommendations for corrective action. The audit organization should communicate to appropriate personnel any deficiencies noted during the monitoring process and make recommendations for appropriate remedial action.

External Peer Review

The audit organization should obtain an external peer review at least once every three years that is sufficient in scope to provide a reasonable basis for determining whether, for the period under review, (1) the reviewed audit organization's system of quality control was suitably designed, and (2) whether the audit organization is complying with its quality control system in order to provide the audit organization with reasonable assurance of conforming with applicable professional standards.

Peer Review Timing

The external peer review requirement, for an audit organization not already subject to a peer review requirement, is effective no later than three years from the date an audit organization begins its first audit in accordance with GAGAS. The period under review generally covers one year, although peer review programs may choose a longer review period. Generally, the deadlines for peer review reports are established by the entity that administers the peer review program. Extensions of the deadlines for submitting the peer review report exceeding three months beyond the due date are granted by the entity that administers the peer review program and GAO.

Peer Review Process

The peer review team should include the following elements in the scope of the peer review:

- Review of the audit organization's quality control policies and procedures
- Consideration of the adequacy and results of the audit organization's internal monitoring procedures
- Review of selected auditor's reports and related documentation
- Review of other documents necessary for assessing compliance with standards, for example, independence documentation, CPE records, and relevant human resource management files
- Interviews with a selection of the reviewed audit organization's professional staff at various levels to assess their understanding of and compliance with relevant quality control policies and procedures

The peer review team should perform an assessment of peer review risk to help determine the number and types of audits to select. Based on the risk assessment, the team should use one or a combination of the following approaches to select individual audits for review with greater emphasis on those engagements in the practice with higher assessed levels of peer review risk:

- Select GAGAS audits that provide a reasonable cross-section of the GAGAS audits performed by the reviewed audit organization, or
- Select audits that provide a reasonable cross-section from all types of work subject to the reviewed audit organization's quality control system, including one or more audits performed in accordance with GAGAS.

The second approach is generally applicable to audit organizations that perform only a small number of GAGAS audits in relation to other types of audits. In these cases, one or more GAGAS audits may represent more than what would be selected when looking at a cross-section of the audit organization's work as a whole.

Peer Review Reporting

The peer review team should prepare one or more written reports communicating the results of the peer review, including the following:

- A description of the scope of the peer review, including any limitations
- An opinion on whether the system of quality control of the reviewed audit organization's audit practices was adequately designed and complied with during the period reviewed to provide the audit organization with reasonable assurance of conforming with applicable professional standards
- Specification of the professional standards to which the reviewed audit organization is being held
- Reference to a separate written communication, if issued under the peer review program

The peer review team uses professional judgment in deciding the type of peer review report. The following are the types of peer review reports:

- *Pass* – A conclusion that the audit organization's system of quality control has been suitably designed and complied with to provide the audit organization with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects.
- *Pass with Deficiencies* – A conclusion that the audit organization's system of quality control has been suitably designed and complied with to provide the audit organization with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects with the exception of a certain deficiency or deficiencies that are described in the report.
- *Fail* – A conclusion, based on the significant deficiencies that are described in the report, that the audit organization's system of quality control is not suitably designed to provide that audit organization with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects or the audit organization has not complied with its system of quality control to provide the audit organization with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects.

When the scope of the reviews is limited by conditions that preclude the application of one or more peer review procedures considered necessary in the circumstances and the peer reviewer cannot accomplish the objectives of those procedures through alternative procedures, the types of reports issued (pass, pass with deficiencies, and fail) are modified by including statements in the report's scope paragraph, body, and opinion paragraph. These statements describe the relationship of the excluded audit(s) or functional area(s) to the reviewed organization's full scope of practice and system of quality control and the effects of the exclusion on the scope and results of the review.

For any deficiencies or significant deficiencies included in the peer review report or other written communication, the peer review team should include, either in the peer review report or in a separate written communication, a detailed description of the findings and recommendations related to the deficiencies or significant deficiencies.

The team performing the peer review should meet the following criteria:

- The review team collectively has current knowledge of GAGAS and government auditing.
- The organization conducting the peer review and individual review team members are independent (as defined in GAGAS) of the audit organization being reviewed, its staff, and the audits selected for the peer review.
- The review team collectively has sufficient knowledge of how to perform a peer review. Such knowledge may be obtained from on-the-job training, training courses, or a combination of both. Having personnel on the peer review team with prior experience on a peer review or internal inspection team is desirable.

Communication of Peer Review Results

An external audit organization should make its most recent peer review report publicly available. For example, an audit organization may satisfy this requirement by posting the peer review report on a publicly available website or to a publicly available file designed for public transparency of peer review results. Alternatively, if neither of these options is available to the audit organization, it should use the same transparency mechanism it uses to make other information public. The audit organization should provide the peer review report to others upon request. If a separate communication detailing findings and recommendations is issued, public availability of that communication is not required. Internal audit organizations that report internally to management and those charged with governance should provide a copy of the peer review report to those charged with governance.

Information in peer review reports may be relevant to decisions on procuring audits. Therefore, audit organizations seeking to enter into a contract to perform an audit in accordance with GAGAS should provide the following to the party contracting for such services when requested:

- The audit organization's most recent peer review report
- Any subsequent peer review reports received during the period of the contract

Auditors who are using another audit organization's work should request a copy of the audit organization's latest peer review report, and any other written communication issued, and the audit organization should provide these documents when requested. This requirement is in addition to any other professional requirements related to group financial statements and component auditors.

Knowledge Check

5. As it relates to peer review, an audit organization performing GAGAS audits should

    a. Obtain an external peer review at least once every two years.
    b. Obtain an external peer review after three years of performing GAGAS audits, then once every five years if there were no deficiencies found.
    c. Obtain an external peer review only if a client has requested a peer review report.
    d. Obtain an external peer review at least once every three years.

6. The peer review team uses professional judgment in deciding the type of peer review report to issue. Which of the following are types of peer review reports?

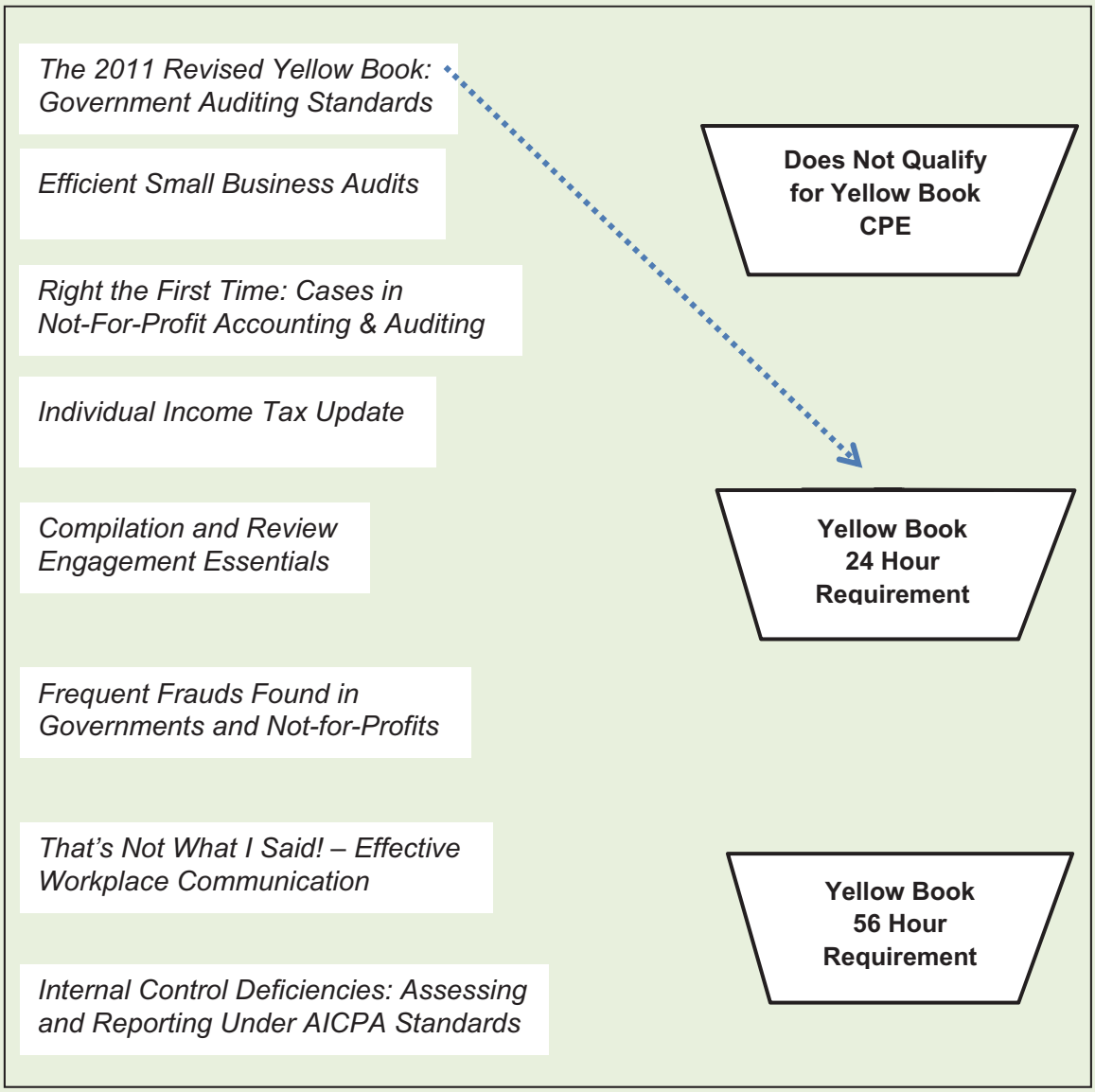
    a. Pass, fail, and fail with deficiencies.
    b. Pass, pass with deficiencies, and fail.
    c. Unmodified, qualified, adverse, and disclaimer.
    d. Pass or disclaimer.

Key Foundational Points

1. In all matters relating to the audit work, the audit organization and the individual auditor, whether government or public must be independent.
   - GAGAS applies a conceptual framework approach to independence.
2. Auditors must use professional judgment in planning and performing audits and attestation engagements and in reporting the results.
3. The staff assigned to perform the audit or attestation engagement must collectively possess adequate professional competence for the tasks required.
   - GAGAS contains CPE requirements.
4. Each audit organization performing audits in accordance with GAGAS must
   - Establish and maintain a system of quality control that is designed to provide the audit organization with reasonable assurance that the organization and its personnel comply with professional standards and applicable legal and regulatory requirements; and
   - Have an external peer review at least once every three years.

Exercise 3-1

In this chapter, we discussed that the Yellow Book's competence standard contains certain CPE requirements. In the left column of this exercise, several CPE courses are listed. Using the limited information provided (course titles only), draw a line to connect the CPE courses listed to the most likely CPE category under the Yellow Book. The first one has been done for you.



Chapter 4

STANDARDS FOR FINANCIAL AUDITS

LEARNING OBJECTIVES

After completing this chapter, you should be able to do the following:

- Recognize the relationship of generally accepted government auditing standards (GAGAS or the Yellow Book) and AICPA Statements on Auditing Standards (SASs).
- Identify the additional GAGAS requirements for performing financial audits.
- Identify the additional GAGAS requirements for reporting on financial audits.
- Recognize what abuse is in the context of GAGAS.
- Identify the elements of a finding.

INTRODUCTION

Chapter 4 of the Yellow Book contains requirements and considerations for performing and reporting on financial audits conducted in accordance with GAGAS. Auditors performing financial audits under GAGAS should comply with the AICPA SASs, which are incorporated into GAGAS by reference.

GAGAS incorporates all sections of the SASs, including the introduction, objectives, definitions, requirements, and application and other explanatory material. Auditors performing financial audits under GAGAS should comply with the SASs and with the additional requirements in chapter 4 of the Yellow Book. The guidance and requirements contained in chapters 1–3 of the Yellow Book also apply to financial audits performed under GAGAS.

Additional GAGAS Requirements for Performing Financial Audits

GAGAS establish requirements for performing financial audits in addition to the requirements contained in the AICPA standards. Auditors should comply with these additional requirements, along with the incorporated SASs, when citing GAGAS in their audit reports.

The Additional GAGAS Requirements for Performing Financial Audits Relate to	
1	auditor communication;
2	previous audits and attestation engagements;
3	fraud, noncompliance with provisions of laws, regulations, contracts, and grant agreements, and abuse;
4	developing elements of a finding; and
5	audit documentation.

Auditor Communication

In addition to the AICPA requirements for auditor communication, when performing a GAGAS financial audit, auditors should communicate pertinent information that in the auditors' professional judgment needs to be communicated to individuals contracting for or requesting the audit, and to cognizant legislative committees when auditors perform the audit pursuant to a law or regulation or when they conduct the work for the legislative committee that has oversight of the audited entity. This requirement does not apply if the law or regulation requiring an audit of the financial statements does not specifically identify the entities to be audited, such as audits required by the Single Audit Act.

In those situations where there is not a single individual or group that both oversees the strategic direction of the entity and the fulfillment of its accountability obligations or in other situations where the identity of those charged with governance is not clearly evident, auditors should document the process followed and conclusions reached for identifying the appropriate individuals to receive the required auditor communications.

Previous Audits and Attestation Engagements

GAGAS requirements related to previous audits and attestation engagements include the following:

- When performing a GAGAS audit, auditors should evaluate whether the audited entity has taken appropriate corrective action to address findings and recommendations from previous engagements that could have a material effect on the financial statements, or other financial data significant to the audit objectives.
- When planning the audit, auditors should ask entity management to identify previous audits, attestation engagements, and other studies that directly relate to the objectives of the audit, including whether related recommendations have been implemented.
- Auditors should use this information in assessing risk and determining the nature, timing, and extent of current audit work, including determining the extent to which testing the implementation of the corrective actions is applicable to the current audit objectives.

Fraud, Noncompliance with Provisions of Laws, Regulations, Contracts, and Grant Agreements, and Abuse

In a GAGAS financial audit, auditors should extend the AICPA requirements pertaining to auditors' responsibility for laws and regulations to also apply to the consideration of compliance with provisions of contracts and grant agreements.

GAGAS states that avoiding interference with investigations or legal proceedings is important in pursuing indications of fraud, noncompliance with provisions of laws, regulations, contracts, and grant agreements, and abuse.

Laws, regulations, or policies may require auditors to report indications of certain types of fraud, noncompliance with provisions of laws, regulations, contracts and grant agreements, and abuse to law enforcement or investigatory authorities before performing additional audit procedures.

When investigations or legal proceedings are initiated or in process, auditors should evaluate the impact on the current audit. In some cases, it may be appropriate for the auditors to work with investigators and legal authorities, or withdraw from or defer further work on the audit engagement or a portion of the engagement to avoid interfering with an ongoing investigation or legal proceeding.

What is Abuse and what is the Auditor's Responsibility Related to It?

GAGAS

States that abuse involves behavior that is deficient or improper when compared with behavior that a prudent person would consider reasonable and necessary business practice given the facts and circumstances. Abuse also includes misuse of authority or position for personal financial interests or those of an immediate or close family member or business associate. Abuse does not necessarily involve fraud, or noncompliance with provisions of laws, regulations, contracts, and grant agreements.

Because the determination of abuse is subjective, auditors are not required to detect abuse in financial audits. However, if auditors become aware of abuse that could be quantitatively or qualitatively material to the financial statements, or other financial data significant to the audit objectives, auditors should apply audit procedures specifically directed to ascertain the potential effect on the financial statements or other financial data significant to the audit objectives. After performing additional work, auditors may discover that the abuse represents potential fraud or noncompliance with provisions of laws, regulations, contracts, and grant agreements.

Developing Elements of a Finding

In a financial audit, findings may involve deficiencies in internal control, fraud, noncompliance with provisions of laws, regulations, contracts, and grant agreements, or abuse. As part of a GAGAS audit, when auditors identify findings, auditors should plan and perform procedures to develop the elements of the findings that are relevant and necessary to achieve the audit objectives.

Four Elements of a Finding	
Criteria	The laws, regulations, contracts, grant agreements, standards, measures, expected performance, defined business practices, and benchmarks against which performance is compared or evaluated. *Criteria* identify the required or desired state or expectation with respect to the program or operation. Criteria provide a context for evaluating evidence and understanding the findings.
Condition	A *condition* is a situation that exists. The condition is determined and documented during the audit.
Cause	The *cause* identifies the reason or explanation for the condition or the factor or factors responsible for the difference between the situation that exists (condition) and the required or desired state (criteria), which may also serve as a basis for recommendations for corrective actions. Common factors include poorly designed policies, procedures, or criteria; inconsistent, incomplete, or incorrect implementation; or factors beyond the control of program management. Auditors may assess whether the evidence provides a reasonable and convincing argument for why the stated cause is the key factor or factors contributing to the difference between the condition and the criteria.
Effect or Potential Effect	The *effect* is a clear, logical link to establish the impact or potential impact of the difference between the situation that exists (condition) and the required or desired state (criteria). The effect or potential effect identifies the outcomes or consequences of the condition. When the audit objectives include identifying the actual or potential consequences of a condition that varies (either positively or negatively) from the criteria identified in the audit, "effect" is a measure of those consequences. Effect or potential effect may be used to demonstrate the need for corrective action in response to identified problems or relevant risks.

Audit Documentation

In addition to the AICPA standards concerning audit documentation, when performing a GAGAS financial audit, auditors should

- document supervisory review, before the report release date, of the evidence that supports the findings, conclusions, and recommendations contained in the author's report; and
- document any departure from the GAGAS requirements and the impact on the audit. This includes documentation of the auditors' conclusions when the audit is not in compliance with applicable GAGAS requirements due to law, regulation, scope limitations, restrictions on access to records, or other issues impacting the audit. This applies to departures from unconditional requirements and presumptively mandatory requirements when alternative procedures performed were not sufficient to achieve the objectives of the requirements.

When performing GAGAS financial audits and subject to applicable provisions of laws and regulations, auditors should make appropriate individuals, as well as audit documentation, available upon request and in a timely manner to other auditors or reviewers.

Underlying GAGAS audits is the premise that audit organizations in federal, state, and local governments and public accounting firms engaged to perform a financial audit in accordance with GAGAS cooperate in auditing programs of common interest so that auditors may use others' work and avoid duplication of efforts. The use of auditors' work by other auditors may be facilitated by contractual arrangements for GAGAS audits that provide for full and timely access to appropriate individuals, as well as audit documentation.

Knowledge Check

1. One of the elements of a finding is criteria. Which of the following is NOT true regarding this element?

    a. This element may not be applicable to some findings.
    b. This element provides a context for evaluating evidence and understanding the finding.
    c. Expected performance may be one criterion.
    d. Laws and regulations may be one criterion.

2. One of the additional requirements of GAGAS in a financial audit relates to previous audits and attestation engagements. What is the primary purpose of this additional requirement?

    a. To determine if the auditor should accept the engagement.
    b. To determine if the auditor should issue an unmodified opinion on the financial statements.
    c. To be able to evaluate the honesty of audited entity officials.
    d. To be able to evaluate if the auditor has taken appropriate corrective action on prior findings.

Additional GAGAS Reporting Requirements for Financial Audits

GAGAS establish requirements for reporting on financial audits in addition to the requirements contained in the AICPA standards. Auditors should comply with these additional requirements, along with the relevant AICPA standards, when citing GAGAS in their audit reports.

The Additional GAGAS Reporting Requirements for Financial Audits Relate to

- reporting auditors' compliance with GAGAS;
- reporting on internal control and compliance with provisions of laws, regulations, contracts, and grant agreements;
- communicating deficiencies in internal control, fraud, noncompliance with provisions of laws, regulations, contracts, and grant agreements, and abuse;
- reporting views of responsible officials;
- reporting confidential or sensitive information; and
- distributing reports.

Reporting Auditors' Compliance with GAGAS

When auditors comply with all applicable GAGAS requirements for financial audits, they should include a statement in the auditors' report that they performed the audit in accordance with GAGAS.

Because GAGAS incorporate by reference the AICPA SASs, auditors are not required to cite compliance with the AICPA standards when citing compliance with GAGAS. Furthermore, an entity receiving a GAGAS audit report may also request auditors to issue a financial audit report for purposes other than complying with requirements for a GAGAS audit. GAGAS do not prohibit auditors from issuing a separate report conforming only to AICPA or other standards.

Reporting on Internal Control, Compliance with Provisions of Laws, Regulations, Contracts, and Grant Agreements

When providing an opinion or a disclaimer on financial statements, auditors should also report on internal control over financial reporting and on compliance with provisions of laws, regulations, contracts or grant agreements that have a material effect on the financial statements. Auditors report on internal control and compliance, regardless of whether or not they identify internal control deficiencies or instances of noncompliance.

Auditors should include either in the same or in separate report(s) a description of the scope of the auditors' testing of internal control over financial reporting and of compliance with provisions of laws, regulations, contracts, or grant agreements. Auditors should also state in the reports whether the tests they performed provided sufficient, appropriate evidence to support opinions on the effectiveness of internal control and on compliance with provisions of laws, regulations, contracts, or grant agreements.

The internal control reporting requirement under GAGAS differs from the objective of an examination of internal control in accordance with the AICPA SSAE, which is to express an opinion on the design or the design and operating effectiveness of an entity's internal control, as applicable. To form a basis for expressing an opinion, the auditor would need to plan and perform the examination to provide a high level of assurance about whether the entity maintained, in all material respects, effective internal control over financial reporting as of a point in time or for a specified period of time. If auditors issue an opinion on internal control, the opinion would satisfy the GAGAS requirement for reporting on internal control.

When auditors report separately (including separate reports bound in the same document) on internal control over financial reporting and on compliance with provisions of laws, regulations, contracts, and grant agreements, they should state in the financial statement auditors' report that they are issuing those additional reports. They should include

- a reference to the separate reports, and
- a statement that the reports on internal control over financial reporting and on compliance with provisions of laws, regulations, contracts, and grant agreements are an integral part of a GAGAS audit in considering the audited entity's internal control over financial reporting and compliance.

Communicating Deficiencies in Internal Control, Fraud, Noncompliance with Provisions of Laws, Regulations, Contracts, and Grant Agreements, and Abuse

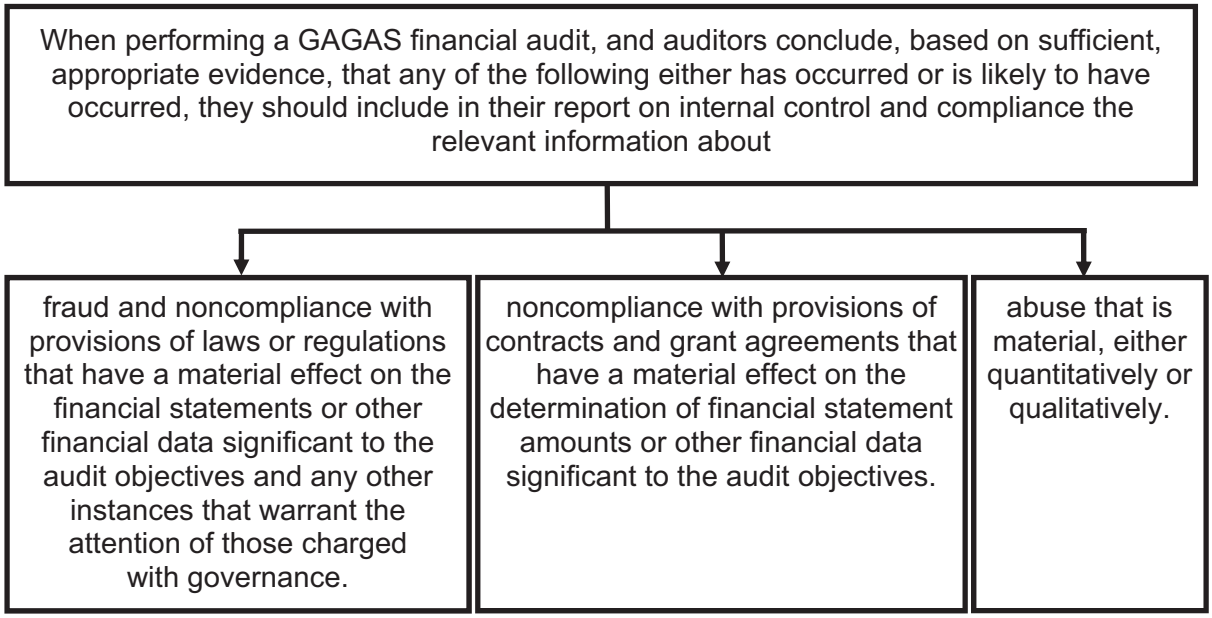
When performing GAGAS financial audits, auditors should communicate in the report on internal control over financial reporting and on compliance

- significant deficiencies and material weaknesses in internal control.
- instances of fraud and noncompliance with provisions of laws and regulations that have a material effect on the financial statements and any other instances that warrant the attention of those charged with governance.
- noncompliance with the provisions of contracts or grant agreements that has a material effect on the determination of financial statement amounts.
- abuse that is material, either quantitatively or qualitatively.

The requirement under AICPA standards to communicate in writing significant deficiencies and material weaknesses identified during an audit form the basis for reporting significant deficiencies and material weaknesses in the GAGAS report on internal control over financial reporting.

The GAGAS requirements regarding the communication of significant deficiencies and material weaknesses apply for all deficiencies identified, including those communicated early.

Fraud, Noncompliance with Provisions of Laws, Regulations, Contracts, and Grant Agreements, and Abuse



When auditors detect noncompliance with provisions of contracts or grant agreements or abuse that have an effect on the financial statements or other financial data significant to the audit objectives that is less than material but that warrants the attention of those charged with governance, they should communicate those findings in writing to officials of the audited entity. Determining whether and how to communicate to entity officials fraud, noncompliance with provisions of laws, regulations, contracts or grant agreements, or abuse that does not warrant the attention of those charged with governance is a matter of professional judgment. Auditors should document such communications.

When fraud, noncompliance with provisions of laws, regulations, contracts, or grant agreements, or abuse either have occurred or are likely to have occurred, auditors may consult with authorities or legal counsel about whether publicly reporting such information would compromise investigative or legal proceedings. Auditors may limit their public reporting to matters that would not compromise those proceedings, and for example, report only on information that is already a part of the public record.

Presenting Findings in the Auditors' Report

When performing a GAGAS financial audit and presenting findings such as deficiencies in internal control, fraud, noncompliance with provisions of laws, regulations, contracts, or grant agreements, or abuse, auditors should develop the elements of the findings to the extent necessary, including findings related to deficiencies from the previous year that have not been remediated. Clearly developed findings assist management or oversight officials in understanding the need for taking corrective action, and assist auditors in making recommendations for corrective action. If auditors sufficiently develop the elements of a finding (see Developing Elements of a Finding section of this chapter), they may provide recommendations for corrective action.

Auditors should place their findings in perspective by describing the nature and extent of the issues being reported and the extent of the work performed that resulted in the finding. To give the reader a basis for judging the prevalence and consequences of these findings, auditors should relate the instances identified to the population or the number of cases examined and quantify the results in terms of dollar value or

other measures, as appropriate. If the results cannot be projected, auditors should limit their conclusions appropriately.

Reporting Findings Directly to Parties Outside the Audited Entity

Auditors should report known or likely fraud, noncompliance with provisions of laws, regulations, contracts, or grant agreements, or abuse directly to parties outside the audited entity in the following two circumstances:

- When entity management fails to satisfy legal or regulatory requirements to report such information to external parties specified in law or regulation, auditors should first communicate the failure to report such information to those charged with governance. If the audited entity still does not report this information to the specified external parties as soon as practicable after the auditors' communication with those charged with governance, then the auditors should report the information directly to the specified external parties.
- When entity management fails to take timely and appropriate steps to respond to known or likely fraud, noncompliance with provisions of laws, regulations, contracts, or grant agreements, or abuse that (1) is likely to have a material effect on the financial statements, and (2) involves funding received directly or indirectly from a government agency, auditors should first report management's failure to take timely and appropriate steps to those charged with governance. If the audited entity still does not take timely and appropriate steps as soon as practicable after the auditors' communication with those charged with governance, then the auditors should report the entity's failure to take timely and appropriate steps directly to the funding agency.

Note that the reporting described here is in addition to any legal requirements to report such information directly to parties outside the audited entity. Auditors should comply with these requirements even if they have resigned or been dismissed from the audit prior to its completion.

Auditors should obtain sufficient, appropriate evidence, such as confirmation from outside parties, to corroborate assertions by management of the audited entity that it has reported such findings in accordance with laws, regulations, or funding agreements. When auditors are unable to do so, they should report such information directly as discussed in this section.

Reporting Views of Responsible Officials

When performing a GAGAS financial audit, if the auditors' report discloses deficiencies in internal control, fraud, noncompliance with provisions of laws, regulations, contracts, or grant agreements, or abuse, auditors should obtain and report the views of responsible officials of the audited entity concerning the findings, conclusions, and recommendations, as well as planned corrective actions.

Providing a draft report with findings for review and comment by responsible officials of the audited entity and others helps the auditors develop a report that is fair, complete, and objective. Including the views of responsible official's results in a report that presents not only the auditors' findings, conclusions, and recommendations, but also the perspectives of the responsible officials of the audited entity and the corrective actions they plan to take. Obtaining the comments in writing is preferred, but oral comments are acceptable.

When auditors receive written comments from the responsible officials, they should include in their report a copy of the officials' written comments, or a summary of the comments received. When the responsible officials provide oral comments only, auditors should prepare a summary of the oral

comments and provide a copy of the summary to the responsible officials to verify that the comments are accurately stated.

Auditors should also include in the report an evaluation of the comments, as appropriate. In cases in which the audited entity provides technical comments in addition to its written or oral comments on the report, auditors may disclose in the report that such comments were received.

Obtaining oral comments may be appropriate when, for example, there is a reporting date critical to meeting a user's needs; auditors have worked closely with the responsible officials throughout the conduct of the work and the parties are familiar with the findings and issues addressed in the draft report; or the auditors do not expect major disagreements with findings, conclusions, and recommendations in the draft report, or major controversies with regard to the issues discussed in the draft report.

When the audited entity's comments are inconsistent or in conflict with the findings, conclusions, or recommendations in the draft report, or when planned corrective actions do not adequately address the auditors' recommendations, the auditors should evaluate the validity of the audited entity's comments. If the auditors disagree with the comments, they should explain in the report their reasons for disagreement. Conversely, the auditors should modify their report as necessary if they find the comments valid and supported with sufficient, appropriate evidence.

If the audited entity refuses to provide comments or is unable to provide comments within a reasonable period of time, the auditors may issue the report without receiving comments from the audited entity. In such cases, the auditors should indicate in the report that the audited entity did not provide comments.

Reporting Confidential or Sensitive Information

When performing a GAGAS financial audit, if certain pertinent information is prohibited from public disclosure or is excluded from a report due to the confidential or sensitive nature of the information, auditors should disclose in the report that certain information has been omitted and the reason or other circumstances that make the omission necessary.

Certain information may be classified or may otherwise be prohibited from general disclosure by federal, state, or local laws or regulations. In such circumstances, auditors may issue a separate, classified, or limited use report containing such information and distribute the report only to persons authorized by law or regulation to receive it.

Additional circumstances associated with public safety, privacy, or security concerns could also justify the exclusion of certain information from a publicly available or widely distributed report. For example, detailed information related to computer security for a particular program may be excluded from publicly available reports because of the potential damage that could be caused by the misuse of this information. In such circumstances, auditors may issue a limited use report containing such information and distribute the report only to those parties responsible for acting on the auditors' recommendations. In some instances, it may be appropriate to issue both a publicly available report with the sensitive information excluded and a limited use report. The auditors may consult with legal counsel regarding any requirements or other circumstances that may necessitate the omission of certain information.

Considering the broad public interest in the program or activity under review assists auditors when deciding whether to exclude certain information from publicly available reports. When circumstances call

for omission of certain information, auditors should evaluate whether this omission could distort the audit results or conceal improper or illegal practices.

When audit organizations are subject to public records laws, auditors should determine whether public records laws could impact the availability of classified or limited use reports and determine whether other means of communicating with management and those charged with governance would be more appropriate. For example, the auditors may communicate general information in a written report and communicate detailed information verbally. The auditors may consult with legal counsel regarding applicable public records laws.

Distributing Reports

Distribution of reports completed under GAGAS depends on the relationship of the auditors to the audited organization and the nature of the information contained in the report. Auditors should document any limitation on report distribution that results from the inclusion of confidential or sensitive information in the report. The following discussion outlines distribution for reports completed under GAGAS.

Public Accounting Firms	Public accounting firms contracted to perform an audit under GAGAS should clarify report distribution responsibilities with the engaging organization. If the contracting firm is to make the distribution, it should reach agreement with the party contracting for the audit about which officials or organizations will receive the report and the steps being taken to make the report available to the public.
Audit Organizations in Government Entities	Audit organizations in government entities should distribute audit reports to those charged with governance, to the appropriate entity officials, and to the appropriate oversight bodies or organizations requiring or arranging for the audits. As appropriate, auditors should also distribute copies of the reports to other officials who have legal oversight authority or who may be responsible for acting on audit findings and recommendations, and to others authorized to receive such reports.
Internal Audit Organizations in Government Entities	Internal audit organizations in government entities may follow the Institute of Internal Auditors (IIA) *International Standards for the Professional Practice of Internal Auditing*. Under GAGAS and IIA standards, the head of the internal audit organization should communicate results to the parties who can ensure that the results are given due consideration. If not otherwise mandated by statutory or regulatory requirements, prior to releasing results to parties outside the organization, the head of the internal audit organization should (1) assess the potential risk to the organization, (2) consult with senior management and legal counsel as appropriate, and (3) control dissemination by indicating the intended users in the report.

Knowledge Check

3. As it relates to presenting findings in the auditors' report, which of the following statements is NOT true?

    a. When presenting finding such as deficiencies in internal control and fraud, auditors should develop the elements of the findings to the extent necessary.
    b. The presentation of findings in the auditors' report includes deficiencies from the prior year that have not been remediated.
    c. Auditors would never provide recommendations for corrective action as part of presenting findings in the auditors' report.
    d. Auditors may provide recommendations for corrective action in certain situations.

Additional GAGAS Considerations for Financial Audits

Due to the audit objectives and public accountability of GAGAS audits, the additional considerations for financial audits completed in accordance with GAGAS may apply. These considerations relate to materiality in GAGAS financial audits and early communication of deficiencies.

Materiality in GAGAS Financial Audits

The AICPA standards require the auditor to apply the concept of materiality appropriately in planning and performing the audit. Additional considerations may apply to GAGAS financial audits of government entities or entities that receive government awards. For example, in audits performed in accordance with GAGAS, auditors may find it appropriate to use lower materiality levels as compared with the materiality levels used in non-GAGAS audits because of the public accountability of government entities and entities receiving government funding, various legal and regulatory requirements, and the visibility and sensitivity of government programs.

Early Communication of Deficiencies

For some matters, early communication to those charged with governance or management may be important because of their relative significance and the urgency for corrective follow-up action. Further, when a control deficiency results in noncompliance with provisions of laws, regulations, contracts, and grant agreements, and abuse, early communication is important to allow management to take prompt corrective action to prevent further noncompliance. Even if a deficiency is communicated early, auditors still need to follow the reporting requirements in GAGAS.

Knowledge Check

4. When performing GAGAS financial audits, auditors should report, based upon the work performed, all of the following, EXCEPT for

    a. Significant deficiencies and material weaknesses in internal control.
    b. Instances of noncompliance with provisions of laws and regulations that have a material effect on the financial statements and any other instances that warrant the attention of those charged with governance.
    c. Noncompliance with provisions of contracts and grant agreements that could have a material effect on the determination of financial statement amounts.
    d. All instances of fraud.

5. When a _____ results in noncompliance with provisions of laws, regulations, contracts, grant agreements, or abuse, early communication is important to allow management to take prompt corrective action to _____ further noncompliance.

    a. Control deficiency/prevent.
    b. Material weakness/evaluate.
    c. Control deficiency/contemplate.
    d. Material weakness/prevent.

6. The auditor should obtain the views of responsible officials for findings reported in the report on internal control and compliance. All of the following types of findings should be addressed in the audited entity's views of responsible officials, EXCEPT for

    a. Noncompliance with provisions of contracts or grant agreements that have a material effect on the determination of financial statement amounts.
    b. Significant deficiencies
    c. Control deficiencies.
    d. Material weaknesses.

Key Foundational Points

1. Auditors performing financial audits under GAGAS should comply with the AICPA SASs and the additional requirements in chapter 4 of GAGAS. The guidance and requirements in chapters 1–3 of GAGAS also apply to a financial audit.
2. The additional GAGAS requirements for performing financial audits relate to
    - auditor communication;
    - previous audits and attestation engagements;
    - fraud, noncompliance with provisions of laws, regulations, contracts, grant agreements, and abuse;
    - developing elements of a finding; and
    - audit documentation.
3. The additional GAGAS reporting requirements for financial audits relate to
    - reporting auditors' compliance with GAGAS;
    - reporting on internal control and compliance with provisions of laws, regulations, contracts, and grant agreements;
    - communicating deficiencies in internal control, fraud, noncompliance with provisions of laws, regulations, contracts, grant agreements, and abuse;
    - reporting views of responsible officials;
    - reporting confidential or sensitive information; and
    - distributing reports.
4. Additional GAGAS considerations for financial audits relate to
    - materiality in GAGAS financial audits; and
    - early communication of deficiencies.

Practice Exercises

Exercise 4-1 (Case Study): Identifying Elements of a Finding

Directions

- Review the information in the right column in the following table regarding the audit of the City of Zahl.
- In the left column, write the basic element of a finding (criteria, condition, effect, or cause) that the information in the right column relates to. The first one has been done for you.

Cause	1. City officials explained that they were familiar with other grant programs where in-kind payments qualified as grant expenditures. They avowed not having read the fine print requirement for Urban Development Action Grant (UDAG) matching payments to be in cash and only for direct costs. The city officials who signed the grant said the matching requirement was not set forth in the documents they signed but acknowledged that it may have been in 20 or so pages of boilerplate attached to the documents.
	2. The city reported final project costs at $830,000 and city expenditures at $190,000. Review of the city records showed that, of the $190,000, a. $110,000 was for land and rights-of-way the city already owned; b. $60,200 was for all allocated salaries of city staff administering grant construction work that was done on contract; and c. $19,800 was for meters and valves the city purchased for the project and provided to the contractor.
	3. The city is required by grant terms to expend $160,000 in matching payments on grant costs. Of the city's reported grant expenditures, only $19,800 qualifies as a matching payment. The difference of $140,200 qualifies as a liability, and this amount is considered material relative to the financial statements.
	4. The city of Zahl was awarded UDAG funding of $800,000 to extend its water and sewer system to a small industrial park. This improvement grant was awarded to attract a wholesale distribution firm that would develop the park and employ up to 100 people. Zahl is located at an intersection of three interstate highways.
	5. Recipients of UDAG funding are required by law to pay 20 percent of the amount of the awarded grant. This matching 20 percent must be in cash and expended on direct costs of the project.
	6. Zahl is a small city by UDAG criteria, and it meets UDAG criteria as a "distressed" area. The city lost 2 small manufacturing plants in the past year with a combined employment of 125 people.

Exercise 4-2 (Case Study): Drafting a Finding

Directions

Review the following information from the audit of an entity:

- During our assessment of the entity's internal controls, we found that the entity was provided $100 million to carry out its programs. Program legislation and regulations imposed several requirements on the use of the funds. The entity has not established internal controls to ensure compliance with these requirements.
- Management of the entity is responsible for complying with laws and regulations. This responsibility includes establishing the necessary internal controls to ensure such compliance. Substantive audit tests for compliance with the requirements applicable to use of the funds did not reveal instances of noncompliance material to the financial statements. However, due to its significance, we consider this condition to be a material weakness in internal controls necessitating reporting. At the time of our audit the entity management had not undertaken the necessary steps to establish appropriate internal controls.
- The prior auditor found the same internal control problem during last year's audit.
- The entity's officials promised that they would establish and maintain internal controls that would help ensure compliance with appropriate laws and regulations.

Using the previous information, draft a finding using the following form. Also, complete the section regarding the auditor's recommendation, which is not required, but may be provided by the auditor. Although the auditor does not draft the management response, draft a response that management might provide to the auditor.

Criteria:	
Condition:	
Effect:	
Cause:	
Recommendation:	
Management Response:	

Chapter 5

Compliance Audits Under the Uniform Guidance

Learning Objectives

After completing this chapter, you should be able to do the following:

- Identify the guidance and requirements found in the Uniform Guidance.
- Recognize how the effective date of the guidance affects various stakeholders.
- Identify key changes for auditors in a compliance audit as a result of the Uniform Guidance.
- Identify key revisions regarding determining major programs.
- Identify key revisions to reporting requirements.

Introduction

This chapter discusses requirements and guidance found in the Uniform Guidance as it relates to an auditor performing a compliance audit under the Uniform Guidance.

Question

Have you read Subpart F, *Audit Requirements*, of the Uniform Guidance?

Introduction

On December 26, 2013, the Office of Management and Budget (OMB) issued Title 2 U.S. *Code of Federal Regulations* (CFR) Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance) which establishes uniform cost principles and audit requirements for federal awards to nonfederal entities and administrative requirements for all federal grants and cooperative agreements.

The Uniform Guidance supersedes guidance in eight circulars, and revises and consolidates the guidance found in those superseded circulars. As it relates to the existing cost principles, the Uniform Guidance consolidates the cost principles (other than those related to hospitals) into a single document with limited variations by type of entity. Combining these various circulars and requirements necessitated revising terms and definitions where applicable.

Agency Implementation

On December 19, 2014, a joint interim final rule was issued containing the implementing regulations of all federal awarding agencies. The regulations issued as part of agency implementation were effective on December 26, 2014. Some agencies received OMB approval for exceptions to the Uniform Guidance. OMB states that it has approved exceptions only when they are consistent with existing policies of the agency. Therefore, all regulatory language included in the joint interim final rule should be consistent with either the Uniform Guidance or the agencies' existing policies and procedures. See the Chief Financial Officers Council document, "Uniform Guidance Crosswalk for Federal Agency Exceptions and Additions," available at https://cfo.gov/wp-content/uploads/2014/12/Agency-Exceptions.pdf, which isolates the exceptions made by agency to determine how any agency exceptions and additions to the federal agency implementation of the Uniform Guidance will affect a particular audit.

Because the agency exceptions are located in a number of locations, it may be challenging for nonfederal entities and their auditors to determine such agency exceptions and the effect of any such exceptions on the audit. Appendix 7, "Other Audit Advisories," of the 2016 Compliance Supplement includes a summary of agency exceptions, by federal agency. Appendix 7 refers to the document noted in the previous paragraph titled, "Uniform Guidance Crosswalk for Federal Agency Exceptions and Additions," posted on COFAR's website (https://cfo.gov/cofar/cofar-resources), and provides a link to some of the agency exceptions that are not found in the electronic CFR. Nonfederal entities and auditors that have questions about the nature of agency exceptions, and the effect of such exceptions on the audit, may consult with agency single audit coordinators or programs officials using the contact information in Appendix 3 of the 2016 Compliance Supplement.

Technical Corrections

Technical corrections and Frequently Asked Questions (FAQs) have been issued that relate to the Uniform Guidance. Auditors should be alert for the issuance of additional technical corrections. The FAQs provide information regarding specific sections of the Uniform Guidance. Additional FAQs are expected and will be available at https://cfo.gov/cofar/#RUUG. See the Resources section for links to the Uniform Guidance and related documents.

Documents Superseded

The Uniform Guidance supersedes seven circulars and a portion of another, as follows:

- OMB Circular A-21, *Cost Principles for Educational Institutions*
- OMB Circular A-87, *Cost Principles for State, Local and Indian Tribal Governments*

- OMB Circular A-110, *Uniform Administrative Requirements for Grants and Other Agreements with Institutions of Higher Education, Hospitals and Other Non-Profit Organizations*
- OMB Circular A-122, *Cost Principles for Non-Profit Organizations*
- OMB Circular A-89, *Catalog of Federal Domestic Assistance*
- OMB Circular A-102, *Grants and Cooperative Agreements With State and Local Governments*
- OMB Circular A-133, *Audits of States, Local Governments and Non-Profit Organizations*
- OMB Circular A-50, on *Single Audit Act follow-up (those sections related to single audits)*

Appendix IX, "Hospital Cost Principles," of the Uniform Guidance notes that the cost principles applicable to hospitals are not superseded with the issuance of the Uniform Guidance. The OMB proposed to establish a review process to consider existing hospital cost determination and how best to update and align them with the cost principle guidance in the Uniform Guidance. Until the revised guidance is implemented for hospitals, the existing principles at 45 CFR Part 74 Appendix E, "Principles for Determining Cost Applicable to Research and Development Under Grants and Contracts with Hospitals," remain in effect.

Hospital Cost Principles

Although the Uniform Guidance did not supersede the hospital cost principles, hospitals are required to comply with the requirements of the Uniform Guidance other than the cost principles.

As evidenced by the subject matter of the circulars, guidance for a variety of areas and types of entities are now housed in the Uniform Guidance. Certain definitions, cost principles, and administrative and other requirements are a consolidation of the superseded guidance from the various circulars. Therefore, it is important to carefully analyze the Uniform Guidance to see how this consolidation of guidance has changed the requirements as it relates to a particular audit engagement. Some of the requirements in the Uniform Guidance are very similar to those found in the superseded circulars. However, there are many differences, large and small, as a result of the consolidation of the circulars and the revision of audit and other requirements.

Summary of Uniform Guidance Subparts

All guidance previously found in the cost principles, circulars, and other documents noted in the previous section is now located in the Uniform Guidance in the following sections of Part 200.

Subpart A, Acronyms and Definitions (200.0–200.99)

Subpart A contains the various acronyms used in the document as well as the definitions. Many of the definitions are a consolidation of those found in a number of circulars, some of which were specific to a particular type of organization (for example, an educational organization). Therefore, definitions that an auditor is accustomed to as they relate to a type of organization may have changed. In addition, some terms that were not previously defined in Circular A-133 or the other superseded circulars have been added to Subpart A. Different definitions may be found in federal statutes or regulations that apply more specifically to particular programs or activities.

Subpart B, General Provisions (200.100–200.113)

Subpart B explains the purpose, applicability, and effective date of the Uniform Guidance. A table is provided that indicates which subparts are applicable to different types of awards. This table specifies the subparts that are applicable (or not applicable) to a particular type of federal award. Among the types of

federal awards noted in the table are grant agreements, cooperative agreements, cost-reimbursement contracts, fixed amount awards, agreements for loans and loan guarantees, interest subsidies, and insurance. The requirements established apply to all federal agencies that make federal awards to nonfederal entities, and are applicable to all costs related to federal awards.

Subpart C, Pre-Federal Award Requirements and Contents of Federal Awards (200.200–200.211)

Subpart C provides information to federal agencies on information that is required to be provided to nonfederal entities related to applying for and receiving federal awards. This includes determining the type of instrument to be used (for example, grant agreement, cooperative agreement, or contract), and a listing of information that must be included in a federal award document. In addition, this subpart provides guidance to federal agencies regarding reviewing proposals, including evaluating risks posed by applicants.

Subpart D, Post Federal Award Requirements (200.300–200.345)

Subpart D contains information for *both federal agencies and nonfederal entities* regarding their responsibilities after a federal award is granted. It covers a wide range of topics. Auditors should identify and understand the content that relates to nonfederal entities because it is one basis for compliance testing of federal awards subject to the Uniform Guidance.

Topics covered in Subpart D include

- standards for financial and program management (including internal control),
- property standards,
- procurement standards,
- performance and program monitoring,
- subrecipient monitoring,
- record retention and access,
- remedies for noncompliance,
- closeout,
- post-closeout adjustments and continuing responsibilities, and
- collection of amounts due.

Subpart E, Cost Principles (200.400–200.475)

Subpart E contains information regarding cost principles for federal awards previously found in the cost circulars. These principles must be used in determining the allowable costs of work performed by the nonfederal entity under federal awards. These principles also must be used by the nonfederal entity as a guide in the pricing of fixed-price contracts and subcontracts where costs are used in determining the appropriate price.

Subpart F, Audit Requirements (200.500–200.521)

Subpart F sets forth the requirements for auditors performing Uniform Guidance compliance audits of nonfederal entities expending federal awards.

Uniform Guidance Appendixes

There are a number of appendixes to the Uniform Guidance on a wide variety of subjects. Some of the appendixes contain detailed information on the subject while others are basically a reference to the material elsewhere. Of special note are the following appendixes, IX–XI, which reference other guidance and requirements related to a single audit:

- Appendix IX, *Hospital Cost Principles*
    - Hospital cost principles have not been revised. The existing principles located at 45 CFR Part 74 Appendix E, entitled "Principles for Determining Cost Applicable to Research and Development Under Grants and Contracts with Hospitals," remain in effect.
- Appendix X, *Data Collection Form (Form SF-SAC)*
    - The data collection form SF-SAC is found on the Federal Audit Clearinghouse (FAC) website.
- Appendix XI, Compliance Supplement
    - The compliance supplement is found on the OMB website.

Effective Date of the Uniform Guidance

Federal Agencies

Under the Uniform Guidance, federal agencies were required to adopt, in unison, revised agency regulations that implement the Uniform Guidance. To accomplish this, all federal agencies were required to revise their existing regulations, policies, and procedures to be in line with the Uniform Guidance. As expected, a joint interim final rule was issued in December 2014 whereby all federal agencies adopted the revisions in unison to be effective on December 26, 2014.

Nonfederal Entities

The Uniform Guidance defines a nonfederal entity as a state, local government, Indian tribe, institution of higher education, or not-for-profit (NFP) organization that carries out a federal award as a recipient or subrecipient. Nonfederal entities are required to implement the Uniform Guidance administrative requirements and cost principles for *all* new federal awards and to certain funding increments made on or after December 26, 2014.

Funding increments issued on or after December 26, 2014, where the agency *modified the terms and conditions of the award*, are subject to the Uniform Guidance.

Funding increments with *no changes to the award terms and conditions* continue to be subject to the applicable pre-Uniform Guidance requirements.

The effective date of the Uniform Guidance as it relates to a subaward is the same as the effective date of the federal award from which the subaward is made.

Election Regarding Procurement Standards

A nonfederal entity may delay implementation of the Uniform Guidance procurement standards for two full fiscal years beginning with the first fiscal year that begins on or after December 26, 2014. For example, the first fiscal year for an entity with a June 30 year end would be the year ending June 30, 2016. If delayed implementation is elected, the entity is required to implement the Uniform Guidance procurement standards beginning July 1, 2017.

The entity must document whether it is in compliance with the old or new standard, and must meet the documented standard.

Auditors

The audit requirements found in the Uniform Guidance are effective for fiscal years beginning on or after December 26, 2014. The first year-ends subject to a compliance audit under the Uniform Guidance are those ending on or after December 25, 2015.

Impact of the Effective Date of the Administrative Requirements and Cost Principles

The effective date of the Uniform Guidance administrative requirements and cost principles may have an impact on compliance audits for a number of years. New federal awards (including funding increments where the terms and conditions of the award were modified) made on or after December 26, 2014, are subject to the Uniform Guidance administrative requirements and cost principles. However, federal awards and funding increments received prior to that date (and funding increments made after the Uniform Guidance effective date that had no modifications to award terms and conditions) continue to be subject to the pre-Uniform Guidance administrative requirements and cost principles.

What does this mean to the auditee?

The effective date of the Uniform guidance administrative requirements and cost principles had an immediate effect on nonfederal entities. Depending on the award dates of their federal awards, two different sources of requirements may apply to the nonfederal entity's awards. Any federal award, or incremental funding for an existing award where there has been a modification in award terms and conditions, received on or after December 26, 2014, is subject to the administrative requirements and cost principles of the Uniform Guidance. Federal awards and funding increments for awards received prior to December 26 are subject to the previously effective guidance, such as that found in Circular A-110 and Circular A-122.

Exercise 5-1

Identify which set of cost principles apply to the federal awards in the table.

Which Cost Principles Apply to this Award?		
Federal Award Funding Period	**Cost Principles Applicable to Award**	
	Circulars	**Uniform Guidance**
01/01/14–12/31/14		
07/01/14–06/30/15		
Funding increment action dated 03/01/15, based on award with original award date of 03/01/13 (award terms and conditions modified)		
01/01/15–12/31/15		
Funding increment action dated 09/01/15, based on award with original award date of 09/01/14 (no change to award terms and conditions)		

What does this mean to the auditor?

Auditors were immediately impacted by the December 26, 2014 effective date of the administrative requirements and cost principles for nonfederal entities. This is because a nonfederal entity may have some federal awards that are subject to the pre-Uniform Guidance requirements and other awards subject to the Uniform Guidance requirements. This may occur within a major program when that major program is funded through multiple funding sources. This situation will continue until all awards subject to the pre-Uniform Guidance requirements have been expended. Whether the audit is performed under Circular A-133 or under the Uniform Guidance has no impact on this.

The result is that auditors may be required to perform tests under both sets of criteria, as determined by the date of the federal award. It is essential that awards subject to the Uniform Guidance requirements be identified early in the planning process. A system for identifying transactions subject to the Uniform Guidance requirements is needed so that a sample clearly identifies which guidance a particular transaction is being tested against.

Knowledge Check

1. Which of the following is not a Subpart within the Uniform Guidance?

    a. Subpart B, *General Provisions.*
    b. Subpart D, *Post Federal Award Requirements.*
    c. Subpart G, *Hospital Cost Principles.*
    d. Subpart E, *Cost Principles.*

Resources

OMB Resources

The Uniform Guidance and related technical corrections and other resources can be found on the Council on Financial Assistance Reform (COFAR) website at https://cfo.gov/COFAR/. Among those resources are links to the guidance itself, an FAQ document, crosswalk documents, and comparisons to preceding guidance. Some of the documents on the website, for example the crosswalk documents, are not based on the final issued guidance and do not include the technical corrections. However, those documents may be helpful in understanding what has changed and where specific content is located in the Uniform Guidance.

AICPA Resources

The AICPA has a number of different resources to assist recipients of federal awards and their auditors in understanding and implementing the reforms. Some of these resources are as follows:

- Government Audit Quality Center (GAQC) website (www.aicpa.org/gaqc)
- Self-study and group study courses
- Periodic webcasts
- Audit Guide, *Government Auditing Standards and Single Audits*
- Audit Risk Alert, *Government Auditing Standards and Single Audit Developments*

Summary of Significant Changes

The Uniform Guidance retains the basic approach to a single audit. Many of the audit requirements in the Uniform Guidance are very similar, or the same as, those found in Circular A-133. However, there are a number of revisions to prior guidance, big and small, found in the Uniform Guidance. While the Uniform Guidance includes requirements and guidance in addition to audit requirements, this discussion will focus on the revisions to the audit requirements.

The information presented in this section does not include all that may be important or relevant to the auditor or auditee. The information is not intended to be a complete listing of differences between audit requirements under Circular A-133 and those under the Uniform Guidance. Instead, this section highlights some of the key changes found in the Uniform Guidance as it relates to the audit requirements. The following areas are discussed in the course:

- Terminology
- Uniform Guidance compliance audits
- Schedule of expenditure of federal awards (SEFA)
- Major program determination
- Reporting

Special Note Regarding Terminology

- Must and should—The Uniform Guidance definition of the terms *must* and *should* are different than those terms as found in generally accepted auditing standards (GAAS) and generally accepted government auditing standards (GAGAS). The Uniform Guidance uses the term
    - *must* to indicate a requirement in the document, and
    - *should* to indicate best practice or recommended approach.

  Under GAAS and GAGAS, the term "must" indicates an unconditional requirement. GAAS and GAGAS define the term "should" as a presumptively mandatory requirement. An auditor must comply with a presumptively mandatory requirement in all cases in which such a requirement is relevant, except in rare cases as noted in that guidance.

- Laws vs federal statutes – In the Uniform Guidance, the phrase "federal statutes, regulations, and the terms and conditions of federal awards," has replaced the phrase used in Circular A-133, that is, "laws, regulations, and the provisions of contracts or grant agreements." Note that variations of these terms are used in some cases in both documents.
- Vendor vs contractor – The term "vendor" is no longer used. The Uniform Guidance replaced the term "vendor" with "contractor." (However, the guidance relating to contractor versus subrecipient determination and characteristics of a payment to a contractor is substantially the same as that found in Circular A-133 relating to vendors.)
- Nonfederal entity – Under the Uniform Guidance, a nonfederal entity is defined as a state, local government, Indian tribe, institution of higher education (IHE), or NFP that carries out a federal award as a recipient or subrecipient. The Circular A-133 definition of the term is a state, local government, or not-for-profit organization.

Uniform Guidance Compliance Audits

As noted previously, the basic approach to a compliance audit under the Uniform Guidance has not changed. However, certain general requirements and guidance have changed. Two of those are covered here.

Threshold

Under the Uniform Guidance, a nonfederal entity that expends $750,000 or more in federal awards during the nonfederal entity's fiscal year must have a single audit or program-specific audit conducted in accordance with the Uniform Guidance. This is an increase from the prior Circular A-133 requirement of $500,000. This change will result in fewer single audits being performed because those organizations with federal expenditures of $500,000 to $749,999 will no longer be required to have a single audit. The Federal Register Notice issuance of the Uniform Guidance notes that this increase in the single audit threshold reduces the audit burden for approximately 5,000 nonfederal entities while maintaining audit coverage of over 99 percent of the federal dollars expended.

Internal Control

The Uniform Guidance now explicitly states that internal controls over federal awards should be in compliance with the *Standards for Internal Control in the Federal Government* (known as the Green Book) or

the Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Question?

Are you aware that the GAO issued the revised Green Book in September 2014? It is available on the GAO website at http://www.gao.gov/greenbook/overview.

Knowledge Check

2. Which of the following statements regarding the use of "must" and "should" in the Uniform Guidance is true?

    a. The definitions of the terms are the same as in GAAS.
    b. The definitions of the terms are the same as in GAAS and GAGAS.
    c. The definitions of the terms are different than in both GAAS and GAGAS.
    d. The definitions of the terms are different than those found in GAAS but the same as in GAGAS.

3. What is the amount of the Uniform Guidance threshold requiring a nonfederal entity to have a single audit?

    a. $500,000.
    b. $1,000,000.
    c. $750,000.
    d. $300,000.

4. Which of the following is true about internal controls over federal awards?

    a. The nonfederal entity should be in compliance with the COSO internal control framework.
    b. The nonfederal entity should be in compliance with the Green Book or the COSO internal control framework.
    c. The nonfederal entity must be in compliance with the COSO internal control framework.
    d. The nonfederal entity must be in compliance with the Green Book if a government, and in compliance with the COSO internal control framework if an NFP.

Schedule of Expenditures of Federal Awards

Under the Uniform Guidance, certain expenditures of federal awards must now be presented on the face of the SEFA, with no option to present these items in the notes to the schedule. This will likely result in a schedule that looks different due to the additional items required to be on the face of the schedule. Items that are now required to be placed on the face of the SEFA are

- total amounts provided to subrecipients from each federal program,
- the total of federal awards expended for loan or loan guarantee programs, and
- other noncash awards (for example, free rent, food commodities, donated property, and the value of insurance in effect).

Other specific provisions in the Uniform Guidance as it relates to the SEFA are as follows:

- The SEFA must include a total for each cluster of programs.
- The notes to the schedule must include whether or not the auditee elected to use the 10 percent *de minimis* indirect cost rate.

As a result of the revisions found in the Uniform Guidance, the total amount of federal expenditures on the face of the SEFA will be the same as the total amount of federal expenditures on the data collection form. This same total will typically be the total used to calculate the type A threshold for determining major programs. (A final type A threshold calculation may be affected by the requirements in CFR 200.518(b)(3) for large loan and loan guarantees.)

Determination of Major Programs

One significant revision in the Uniform Guidance relates to major program determination. The process of identifying the major programs to audit remains a four-step process. However, there are a number of changes within the process. The table found later in this section titled "Summary of Differences" provides a comparison of some of the more significant differences between the Circular A-133 requirements and the related Uniform Guidance requirements regarding the identification of major programs.

The Uniform Guidance states that the auditor must use a risk-based approach to determine which federal programs are major programs. This risk-based approach must include consideration of current and prior audit experience, the oversight by federal agencies and pass-through entities, and the inherent risk of the federal program. Note that the provision has been retained whereby a federal awarding agency may request the OMB to approve that a type A program not be considered low risk for a certain entity.

Step One

The auditor must identify the larger federal programs, which must be labeled type A programs. Type A programs are defined as federal programs with federal awards expended during the audit period exceeding the levels outlined in the following table:

Total Federal Awards Expended[1]	Type A Threshold
Equal to or exceed $750,000 but less than or equal to $25 million	$750,000
Exceed $25 million but less than or equal to $100 million	Total federal awards expended times 0.03
Exceed $100 million but less than or equal to $1 billion	$3 million
Exceed $1 billion but less than or equal to $10 billion	Total federal awards expended times 0.003
Exceed $10 billion but less than or equal to $20 billion	$30 million
Exceed $20 billion	Total federal awards expended times 0.0015
[1] Includes both cash and noncash awards.	

Federal programs not labeled type A must be labeled type B programs.

The inclusion of large loan and loan guarantees (loans) should not result in the exclusion of other programs as type A programs. (Note that the Uniform Guidance includes requirements regarding the treatment of large loan and loan guarantee programs. That guidance was formerly found in the Compliance Supplement.)

For biennial audits, the determination of type A and type B programs must be based upon the federal awards expended during the two-year period.

Step Two

The auditor must identify type A programs that are low risk. In making this determination, the auditor must consider whether the stated criteria indicate significantly increased risk and preclude the program from being low risk. For a type A program to be considered low risk, it must have been

- audited as a major program in at least one of the two most recent audit periods (in the most recent audit period in the case of a biennial audit), and
- in the most recent audit period, the program must have not had
    - internal control deficiencies that were identified as material weaknesses in the auditor's report on internal control for major programs;
    - a modified opinion on the program in the auditor's report on major programs; or
    - known or likely questioned costs that exceed five percent of the total federal awards expended for the program.

Note

The Uniform Guidance is very specific as to the criteria to be used in evaluating the risk of type A programs. Under the Uniform Guidance, the auditor is not permitted to use judgment based on the inherent risk of a type A program.

Step Three

The auditor must identify type B programs that are high risk using professional judgment and the criteria in 2 CFR 200.519, *Criteria for Federal Program Risk*. However, the auditor is not required to identify more high-risk type B programs than at least one-fourth the number of type A programs identified as low risk under Step 2. Once that threshold is met, risk assessment of type B programs is discontinued.

The Uniform Guidance does not require a specific number of high-risk type B programs to be identified or audited as major programs. It is possible to risk assess all of an auditee's type B programs that are required to be assess for risk and determine that fewer than the calculated number (one fourth the number of low-risk type A programs) are high-risk type B programs, or that none are high-risk type B programs. Any program determined to be a high-risk type B program is required to be audited as a major program.

Note

Under the Uniform Guidance, all type B programs identified as high risk are required to be audited as major programs. To the extent an auditor performs risk assessments on type B programs beyond what is required under the Uniform Guidance, and identifies more high-risk type B programs than necessary, those additional programs must be audited as major programs.

Except for known material weaknesses in internal control or compliance problems, a single criterion would seldom cause a type B program to be considered high risk. However, the presence of one of the criterion noted does not, by itself, indicate a type B program must automatically be identified by the auditor as high risk. Instead, the auditor considers the criteria and uses judgment to determine if a program should be identified as a high-risk type B program. When determining which type B programs to risk-assess, the auditor is encouraged to use an approach that provides an opportunity for different high-risk type B programs to be audited as major over a period of time.

Note: The auditor is not expected to perform risk assessments on relatively small federal programs. Therefore, the auditor is only required to perform risk assessments on type B programs that exceed 25 percent of the type A threshold as determined in Step 1. For example, if the audit threshold is $750,000 for a particular audit, programs with federal awards expended of $187,500 or less are not required to be assessed for risk.

Step Four:

At a minimum, the auditor must audit all of the following as major programs:

- All type A programs not identified as low risk under step two
- All type B programs identified as high risk under step three
- Programs to be audited as major based on a federal agency or pass-through entity request
- Such additional programs as may be necessary to comply with the percentage of coverage requirements.

Percentage of Coverage

If the auditee meets the criteria for a low-risk auditee, the auditor must audit major programs with federal awards expended that, in aggregate, encompass at least 20 percent of total federal awards expended. Otherwise, the auditor must audit major programs with federal awards expended that, in aggregate, encompass at least 40 percent of total federal awards expended.

Major Program Determination: Circular A-133 vs Uniform Guidance

The table that follows provides an indication of differences between the processes and criteria used in the two sets of guidance. The differences shown are not all the differences and may not be indicative of the entire process; for example, there may be a part of a step where there are no differences between Circular A-133 and the Uniform Guidance.

Some Differences Between Circular A-133 and Uniform Guidance Major Program Determination

Related to Step Number	Circular A-133	Uniform Guidance
1	Minimum type A/B threshold is $300,000	Minimum type A/B threshold is $750,000
1	When a federal program providing loans significantly affects the number or size of type A programs, the auditor should consider this program a type A program and exclude its value in determining other type A programs.	When a federal program providing loans exceeds four times the largest non-loan program, it is considered a large loan program, and the auditor must consider this federal program as a type A program and exclude its values in determining other type A programs.
		A program is only considered to be a federal program providing loans if the value of the federal awards expended for loans within the program comprises 50 percent or more of the total federal awards expended for the program.
2	A prior year significant deficiency or material weakness in internal control for a major program classifies a program as other than low risk.	A prior year material weakness in internal control for a major program classifies a program as other than low risk.
2	Identification of low-risk type A programs: The type A program is not low risk if, in the most recent audit period, it had any audit finding. Items to note include the following: ▪ A significant deficiency or material weakness in internal control indicates other-than-low risk. ▪ Auditor judgment is allowed as it relates to certain types of findings that would allow a program to be considered low risk.	Identification of low-risk type A programs: The type A program is not low risk if, in the most recent audit period, it had certain high-risk audit findings and includes the following: ▪ Modified opinion ▪ Material weakness in internal control ▪ Known or likely questioned costs exceeding five percent of total program expenditures

Related to Step Number	Circular A-133	Uniform Guidance
	The auditor considers risk related to ▪ federal or pass-through entity (PTE) oversight; ▪ inherent risk; ▪ results of audit follow-up; and ▪ changes in personnel or systems.	The auditor considers risk related to ▪ federal or PTE oversight; ▪ results of audit follow-up; and ▪ changes in personnel or systems.
3	Regarding how many type B programs are required to be risk-assessed: Under option 1, the auditor is required to perform risk assessments on all type B programs before the selection of major programs in step 4 commences. Under option 2, the auditor is not required to identify more high-risk type B programs than the number of low-risk type A programs. (The exclusion for small type B programs applies to both options 1 and 2.)	Regarding how many type B programs are required to be risk-assessed: The auditor is required to perform risk assessments on type B programs until the calculated number (one-fourth the number of low-risk type A programs) of type B programs are identified as high-risk type B programs, or until there are no more type B programs required to be assessed for risk.
3	Exclusion for small type B program risk assessment: The auditor is required to perform risk assessments on type B programs that exceed ▪ the larger of $100,000 or .003 of total federal awards expended when the auditee has less than or equal to $100 million of federal awards expended, or ▪ $300,000 or .0003 of total federal awards expended when the auditee has more than $100 million of federal awards expended.	Exclusion for small type B program risk assessment: The auditor is required to perform risk assessments on type B programs that exceed 25 percent of the type A threshold.

Related to Step Number	Circular A-133	Uniform Guidance
4	Number of high-risk type B programs to be audited as major: Two options are provided: ▪ Option 1 – The auditor is required to audit as major at least one-half of the high-risk type B programs, not to exceed the number of low-risk type A programs.	Number of high-risk type B programs to be audited as major: The auditor is required to audit as major any type B programs identified as high risk in step 3. There is no required number of high-risk type B programs that must be audited as a major program.
	▪ Option 2 – The auditor is required to audit as major one high-risk type B program for every low-risk type A program.	
4	Percentage of coverage: Requires 50 percent of federal awards to be audited as major. For low-risk auditees, this number is decreased to 25 percent.	Percentage of coverage: Requires 40 percent of federal awards to be audited as major. For low-risk auditees, this number is decreased to 20 percent.
General	First year audit exception: In a first year audit, the auditor may elect to audit as major all type A programs plus any type B programs necessary to meet the percentage of coverage requirements.	Removed.

Low-Risk Auditee Requirements

The requirements to be met in order for a nonfederal entity to qualify as a low-risk auditee have been revised under the Uniform Guidance. An auditee that meets all of the following conditions for each of the preceding two audit periods must qualify as a low-risk auditee and be eligible for reduced audit coverage in accordance with the section dealing with major program determination:

- The entity must have had single audits performed on an annual basis. A nonfederal entity that has biennial audits does not qualify as a low-risk auditee.
- The entity must have submitted the data collection form and reporting package to the FAC on time.
- The auditor's opinion on whether the entity's financial statements were prepared in accordance with generally accepted accounting principles (GAAP) (or a basis of accounting required by state law) and the auditor's in-relation-to opinion on the SEFA were unmodified. Therefore, non-GAAP financial statements (unless required by state law) mean other than low-risk auditee status.
- The entity had no deficiencies in internal control that were identified as material weaknesses under the Yellow Book.
- The auditor did not report a substantial doubt about the entity's ability to continue as a going concern.

- None of the entity's federal programs had audit findings from any of the following in either of the preceding two audit periods in which they were classified as type A programs:
    - Internal control deficiencies that were identified as material weaknesses in the auditor's report on internal control for major programs
    - A modified opinion on a major program in the auditor's report on major programs
    - Known or likely questioned costs that exceeded five percent of the total federal awards expended for a type A program during the audit period

The provision in Circular A-133 that allowed a nonfederal entity with biennial audits to qualify as a low-risk auditee if agreed to in advance by the cognizant or oversight agency was removed. In addition, the provisions in Circular A-133 that allowed a cognizant or oversight agency to provide a waiver in certain situations were removed.

Uniform Guidance Compliance Audit Reporting

The Uniform Guidance revised the requirements related to reporting in several areas. The more significant revisions are noted here.

Audit Findings

Audit Findings Reported

Under the Uniform Guidance, the auditor must report the following as audit findings in a schedule of findings and questioned costs:

- Significant deficiencies and material weaknesses in internal control over major programs and significant instances of abuse relating to major programs.
- Material noncompliance with the provisions of federal statutes, regulations, or the terms and conditions of federal awards related to a major program.
- Known questioned costs that are greater than $25,000 for a type of compliance requirement for a major program. The auditor must also report known questioned costs when likely questioned costs are greater than $25,000 for a type of compliance requirement for a major program.
- Known questioned costs that are greater than $25,000 for a federal program which is not audited as a major program.
- The circumstances concerning why the auditor's report on compliance for each major program is other than an unmodified opinion, unless such circumstances are otherwise reported as audit findings in the schedule of findings and questioned costs.
- Known or likely fraud affecting a federal award, unless such fraud is otherwise reported as an audit finding in the schedule of findings and questioned costs.
- Instances in which the results of audit follow-up procedures disclosed that the summary schedule of prior audit findings, prepared by the auditee, materially misrepresents the status of any prior audit finding.

Audit Findings Detail

The required audit findings detail under the Uniform Guidance was revised. This includes both revision of the prior requirements and the addition of new ones. Under the Uniform Guidance, the following specific information must be included, as applicable, in audit findings:

- Federal program and specific federal award identification including the CFDA title and number, federal award identification number and year, name of federal agency, and name of the applicable pass-through entity.
- The criteria or specific requirement upon which the audit finding is based, including the federal statutes, regulations, or the terms and conditions of the federal awards.
- The condition found, including facts that support the deficiency identified in the audit finding.

- A statement of cause that identifies the reason or explanation for the condition or the factors responsible for the difference between the situation that exists (condition) and the required or desired state (criteria), which may also serve as a basis for recommendations for corrective action.
- The possible asserted effect to provide sufficient information to the auditee and federal agency, or pass-through entity in the case of a subrecipient, to permit them to determine the cause and effect to facilitate prompt and proper corrective action.
- Identification of questioned costs and how they were computed. Known questioned costs must be identified by applicable CFDA number(s) and applicable federal award identification number(s).
- Information to provide proper perspective for judging the prevalence and consequences of the audit findings, such as whether the audit findings represent an isolated instance or a systemic problem. Where appropriate, instances identified must be related to the universe and the number of cases examined and be quantified in terms of dollar value. It is recommended, but not required, that the auditor report whether the sampling was a statistically valid sample.
- Identification of whether the audit finding was a repeat of a finding in the immediately prior audit and, if so, any applicable prior year audit finding numbers.
- Recommendations to prevent future occurrences of the deficiency identified in the audit finding.
- Views of responsible officials of the auditee (not only when there is disagreement with the audit finding).

Each audit finding in the schedule of findings and questioned costs must include a reference number in the format meeting the requirements of the data collection form submission to allow for easy referencing of the audit findings during follow-up.

Other Revisions Related to Reporting

- Summary schedule of prior audit findings. The auditee must prepare a summary schedule of prior audit findings that must report the status of all audit findings included in the prior audit's schedule of findings and questioned costs. Also required to be included are audit findings reported in the prior audit's summary schedule of prior audit findings that have not been fully resolved.
- Corrective action plan. The Uniform Guidance states that the auditee must prepare a corrective action plan for current year audit findings. The correct action plan must be a separate document from the summary schedule of prior audit findings.
- Findings to be included. The corrective action plan and summary schedule of prior audit findings must now include findings relating to the financial statements that are required to be reported in accordance with GAGAS.
- Extensions of due dates. Federal agencies no longer have the authority to grant extensions of the due date of reports.
- Data collection form. All federal agencies, pass-through entities, and others interested in a reporting package and data collection form must obtain it by accessing the FAC.

Note: Subrecipients are no longer required to submit a reporting package to a pass-through entity as previously required. This change is due to the public availability of FAC reporting packages.

Federal Audit Clearinghouse

The FAC must make the reporting packages received available to the public, maintain a database of completed audits, provide appropriate information to federal agencies, and follow up with known auditees that have not submitted the required data collection forms and reporting packages.

Note: There is an exception for Indian tribes. An auditee that is an Indian tribe may opt to not authorize the FAC to make the reporting package publicly available online by excluding the authorization for the FAC publication in the statement just described. If this option is exercised, the auditee becomes responsible for submitting the reporting package directly to any pass-through entities through which it

has received a federal award and to pass-through entities for which the summary schedule of prior audit findings reported the status of any findings related to federal awards that the pass-through entity provided. Unless restricted by federal statute or regulation, if the auditee opts not to authorize publication, it must make copies of the reporting package available for public inspection

Protected Personally Identifiable Information (PII)

The Uniform Guidance has added guidance regarding the use of personal information. Auditees and auditors must ensure that their respective parts of the reporting package do not include protected PII.

PII is information that can be used to distinguish or trace an individual's identity, either alone or when combined with other personal or identifying information that is linked or linkable to a specific individual. Some information that is considered to be PII is available in public sources such as telephone books, public websites, and university listings. This type of information is considered to be public PII and includes, for example, first and last name, address, work telephone number, email address, home telephone number, and general educational credentials. The definition of PII is not anchored to any single category of information or technology. Rather, it requires a case-by-case assessment of the specific risk that an individual can be identified. Non-PII can become PII whenever additional information is made publicly available, in any medium and from any source, that, when combined with other available information, could be used to identify an individual.

Protected PII means an individual's first name or first initial and last name in combination with any one or more types of information, including, but not limited to, social security number, passport number, credit card numbers, clearances, bank numbers, biometrics, date and place of birth, mother's maiden name, criminal, medical, and financial records, and educational transcripts. This does not include PII that is required by law to be disclosed.

OMB Compliance Supplement for Single Audits

The OMB Compliance Supplement, updated yearly, is one of the most important sources of guidance for the auditor performing single audits. The supplement identifies the compliance requirements that OMB and the federal agencies expect to be considered as part of a single audit. It provides information for auditors to understand federal program objectives, procedures, and compliance requirements as well as audit objectives and suggested audit procedures for the programs included in the supplement.

The Compliance Supplement now contains 12 types of compliance requirements. As part of the 2015 update to the supplement, two types of compliance requirements were removed—"Davis-Bacon" and "Real Property Acquisition and Relocation Assistance." Also, the "Period of Availability of Federal Funds" type of compliance requirement was renamed "Period of Performance."

In addition, Part 3.2 was added to reflect changes resulting from issuance of 2 CFR Part 200 (Uniform Guidance). Therefore, Part 3 of the Compliance Supplement contains the following:

- Part 3.1 applies to testing federal awards that are subject to the pre-Uniform Guidance requirements (that is, federal awards made prior to December 26, 2014.)
- Part 3.2 applies to testing federal awards subject to the Uniform Guidance requirements (that is, new federal awards and funding increments with modified award terms and conditions made on or after December 26, 2014.)

As noted previously, a major program may include expenditures from both federal awards subject to the pre-Uniform Guidance requirements, as well as federal awards subject to the Uniform Guidance requirements. In these situations, the auditor will use both Part 3.1 and 3.2, as applicable to the award, to perform compliance testing.

Knowledge Check

5. The OMB Compliance Supplement lists how many types of compliance requirements to be considered in a federal single audit going forward?

    a. 14.
    b. 11.
    c. 10.
    d. 12.

EXEMPT ORGANIZATIONS GLOSSARY

GOVERNMENTAL TERMINOLOGY

Accounting System – The methods and records established to identify, assemble, analyze, classify, record, and report a government's transactions and to maintain accountability for the related assets and liabilities.

Accrual Basis of Accounting – The recording of financial effects on a government of transactions and other events and circumstances that have consequences for the government in the periods in which those transactions, events, and circumstances occur, rather than only in the periods in which cash is received or paid by the government.

Ad Valorem Tax – A tax based on value (such as a property tax).

Advance From Other Funds – An asset account used to record noncurrent portions of a long-term debt owed by one fund to another fund within the same reporting entity. (See **Due to Other Funds** and *Interfund Receivable/Payable*).

Agency Funds – A fund normally used to account for assets held by a government as an agent for individuals, private organizations or other governments and/or other funds.

Appropriation – A legal authorization granted by a legislative body to make expenditures and to incur obligations for specific purposes. An appropriation is usually limited in amount and time it may be expended.

Assigned Fund Balance – A portion of fund balance that includes amounts that are constrained by the government's intent to be used for specific purposes, but that are neither restricted nor committed.

Basis of Accounting – A term used to refer to *when* revenues, expenditures, expenses, and transfers, and related assets and liabilities are recognized in the accounts and reported in the financial statements. Specifically, it relates to the timing of the measurements made, regardless of the nature of the measurement. (See **Accrual Basis of Accounting, Cash Basis of Accounting,** and **Modified Accrual Basis of Accounting**).

Bond – A written promise to pay a specified sum of money (the face value or principal amount) at a specified date or dates in the future (the maturity dates[s]), together with periodic interest at a specified rate. Sometimes, however, all or a substantial part of the interest is included in the face value of the security. The difference between a note and bond is that the latter is issued for a longer period and requires greater legal formality.

Business Type Activities – Those activities of a government carried out primarily to provide specific services in exchange for a specific user charge.

Capital Grants – Grants restricted by the grantor for the acquisition and/or construction of (a) capital asset(s).

Capital Projects Fund – A fund used to account for and report financial resources that are restricted, committed, or assigned to expenditures for capital outlays, including the acquisition or construction of capital facilities and other capital assets. Capital project funds exclude those types of capital-related outflows financed by proprietary funds or for assets that will be held in trust for individuals, private organizations, or other governments.

Cash Basis of Accounting – A basis of accounting that requires the recognition of transactions only when cash is received or disbursed.

Committed Fund Balance – A portion of fund balance that includes amounts that can only be used for specific purposes pursuant to constraints imposed by formal action of the government's highest level of decision-making authority.

Consumption Method – The method of accounting that requires the recognition of an expenditure/expense as inventories are used.

Contributed Capital – Contributed capital is created when a general capital asset is *transferred* to a proprietary fund or when a grant is received that is externally restricted to capital acquisition or construction. Contributions restricted to capital acquisition and construction and capital assets received from developers are reported in the operating statement as a separate item after nonoperating revenues and expenses.

Debt Service Fund – A fund used to account for and report financial resources that are restricted, committed, or assigned to expenditure for principal and interest. Debt service funds should be used to report resources if legally mandated. Financial resources that are being accumulated for principal and interest maturing in future years should also be reported debt service funds.

Deferred Revenue – Amounts for which asset recognition criteria (receivable) have been met, but for which revenue recognition criteria have not been met. Under the modified accrual basis of accounting, amounts that are measurable but not available are classified as deferred revenue. Cash received in advance of the period of applicability is also recorded as deferred revenue.

Deficit – (a) The excess of the liabilities of a fund over its assets. (b) The excess of expenditures over revenues during an accounting period, or in the case of proprietary funds, the excess of expenses over revenues during an accounting period.

Disbursement – A payment made in cash or by check. Expenses are only recognized at the time physical cash is disbursed.

Due From Other Funds – A current asset account used to indicate account reflecting amounts owed to a particular fund by another fund for goods sold or services rendered. This account includes only short-term obligations on open account, not interfund loans.

Due to Other Funds – A current liability account reflecting amounts owed by a particular fund to another fund for goods sold or services rendered. This account includes only short-term obligations on an open account, not interfund loans.

Fund Financial Statements – Each fund has its own set of self-balancing accounts and fund financial statements that focus on information about the government's governmental, proprietary, and fiduciary fund types.

Enabling Legislation – Legislation that authorizes a government to assess, levy, charge, or otherwise mandate payment of resources from external resource providers, and includes a legally enforceable requirement that those resources be used for the specific purposes stipulated in the legislation.

Encumbrances – Commitments related to unperformed (executory) contracts for goods or services. Used in budgeting, encumbrances are *not* GAAP expenditures or liabilities, but represent the estimated amount of expenditures ultimately to result if unperformed contracts in process are completed.

Enterprise Fund – A fund established to account for operations financed and operated in a manner similar to private business enterprises (such as gas, utilities, transit systems, and parking garages). Usually, the governing body intends that costs of providing goods or services to the general public be recovered primarily through user charges.

Expenditures – Decreases in net financial resources. Expenditures include current operating expenses requiring the present or future use of net current assets, debt service and capital outlays, intergovernmental grants, entitlements, and shared revenues.

Expenses – Outflows or other using up of assets or incurrences of liabilities, or a combination of both, from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations.

Fund – A fiscal and accounting entity with a self-balancing set of accounts in which cash and other financial resources, all related liabilities and residual equities, or balances, and changes therein, are recorded and segregated to carry on specific activities or attain certain objectives in accordance with special regulations, restrictions, or limitations.

Fund Balance – The difference between fund assets and fund liabilities of the generic fund types within the governmental category of funds.

Fund Type – The 11 generic funds that all transactions of a government are recorded into. The 11 fund types are as follows: general, special revenue, debt service, capital projects, permanent, enterprise, internal service, private purpose trust, pension trust, investment trust, and agency.

GASB – The Governmental Accounting Standards Board (GASB) was organized in 1984 by the Financial Accounting Foundation (FAF) to establish standards of financial accounting and reporting for state and local governmental entities. Its standards guide the preparation of external financial reports of those entities.

General Fund – The fund within the governmental category used to account for all financial resources except those required to be accounted for in another governmental fund.

General-Purpose Governments – General-purpose governments are governmental entities that provide a range of services, such as states, cities, counties, towns, and villages.

Governmental Funds – Funds used to account for the acquisition, use, and balances of spendable financial resources and the related current liabilities, except those accounted for in proprietary funds and fiduciary funds. Essentially, these funds are accounting segregations of financial resources. Spendable assets are assigned to a particular government fund type according to the purposes for which they may or must be used. Current liabilities are assigned to the fund type from which they are to be paid. The difference between the assets and liabilities of governmental fund types is referred to as fund balance. The measurement focus in these funds types is on the determination of financial position and changes in financial position (sources, uses, and balances of financial resources) rather than on net income determination.

Government-Wide Financial Statements – The government-wide financial statements are highly aggregated financial statements that present financial information for all assets (including infrastructure capital assets), liabilities, and net assets of a primary government and its component units, except for fiduciary funds. The government-wide financial statements use the economic resources measurement focus and accrual basis of accounting.

Infrastructure Assets – Infrastructure assets are long-lived capital assets that normally are stationary in nature and normally can be preserved for a significantly greater number of years than most capital assets. Examples of infrastructure assets are roads, bridges, tunnels, drainage systems, water and sewer systems, dams, and lighting systems. Buildings, except those that are an ancillary part of a network of infrastructure assets, are not considered infrastructure assets.

Internal Service Fund – A generic fund type within the proprietary category used to account for the financing of goods or services provided by one department or agency to other departments or agencies of a government, or to other governments, on a cost-reimbursement basis.

Investment Trust Fund – A generic fund type within the fiduciary category used by a government in a fiduciary capacity, such as to maintain its cash and investment pool for other governments.

Major Funds – A government's general fund (or its equivalent), other individual governmental type, and enterprise funds that meet specific quantitative criteria, and any other governmental or enterprise fund that a government's officials believe is particularly important to financial statement users.

Management's Discussion and Analysis (MD&A) – MD&A is RSI that introduces the basic financial statements by presenting certain financial information as well as management's analytical insights on that information.

Measurement Focus – The accounting convention that determines (a) which assets and which liabilities are included on a government's balance sheet and where they are reported, and (b) whether an operating statement presents information on the flow of financial resources (revenues and expenditures) or information on the flow of economic resources (revenues and expenses).

Modified Accrual Basis of Accounting – The basis of accounting adapted to the governmental fund type measurement focus. Revenues and other financial resource increments are recognized when they become both *measurable* and *available to finance expenditures of the current period. Available* means collectible in the current period or soon enough thereafter to be used to pay liabilities of the current period. Expenditures are recognized when the fund liability is incurred and expected to be paid from current resources except for (a) inventories of materials and supplies that may be considered expenditures either when purchased or when used, and (b) prepaid insurance and similar items that may be considered expenditures either when paid for or when consumed. All governmental funds are accounted for using the modified accrual basis of accounting in fund financial statements.

Modified Approach – Rules that allow infrastructure assets that are part of a network or subsystem of a network not to be depreciated as long as certain requirements are met.

Nonspendable Fund Balance – The portion of fund valance that includes amounts that cannot be spent because they are either (a) not in spendable form, or (b) legally or contractually required to be maintained intact.

Pension Trust Fund – A trust fund used to account for a PERS. Pension trust funds use the accrual basis of accounting and the flow of economic resources measurement focus.

Permanent Fund – A generic fund type under the governmental category used to report resources that are legally restricted to the extent that only earnings, and not principal, may be used for purposes that support the reporting government's programs and, therefore, are for the benefit of the government or its citizenry. (Permanent funds do not include private-purpose trust funds, which should be used when the government is required to use the principal or earnings for the benefit of individuals, private organizations, or other governments).

Private Purpose Trust Fund – A general fund type under the fiduciary category used to report resources held and administered by the reporting government acting in a fiduciary capacity for individuals, other governments, or private organizations.

Proprietary Funds – The government category used to account for a government's ongoing organizations and activities that are similar to those often found in the private sector (these are enterprise and internal service funds). All assets, liabilities, equities, revenues, expenses, and transfers relating to the government's business and quasi-business activities are accounted for through proprietary funds. Proprietary funds should apply all applicable GASB pronouncements and those GAAP applicable to similar businesses in the private sector, unless those conflict with GASB pronouncements. These funds use the accrual basis of accounting in conjunction with the flow of economic resources measurement focus.

Purchases Method – The method under which inventories are recorded as expenditures when acquired.

Restricted Fund Balance – Portion of fund valance that reflects constraints placed on the use of resources (other than nonspendable items) that are either (a) externally imposed by creditor such as through debt covenants, grantors, contributors, or laws or regulations of other governments, or (b) imposed by law through constitutional provisions or enabling legislation.

Required Supplementary Information (RSI) – GAAP specify that certain information be presented as RSI.

Special-Purpose Governments – Special-purpose governments are legally separate entities that perform only one activity or only a few activities, such as cemetery districts, school districts, colleges and universities, utilities, hospitals and other health care organizations, and public employee retirement systems.

Special Revenue Fund – A fund that *must* have revenue or proceeds from specific revenue sources which are either restricted or committed for a specific purpose other than debt service or capital projects. This definition means that in order to be considered a special revenue fund, there must be one or more revenue sources upon which reporting the activity in a separate fund is predicated.

Transfers – All interfund transfers, such as legally authorized transfers from a fund receiving revenue to a fund through which the resources are to be expended, where there is no intent to repay. Interfund transfers are recorded on the operating statement.

Unassigned Fund Balance – Residual classification for the general fund. This classification represents fund balance that has not been assigned to other funds and that has not been restricted, committed, or assigned to specific purposes within the general fund. The general fund should be the only fund that reports a positive unassigned fund valance amount. In other funds, if expenditures incurred for specific purposes exceeded the amounts restricted, committed, or assigned to those purposes,

Unrestricted Fund Balance – The total of committed fund balance, assigned fund balance, and unassigned fund balance.

Not-for-Profit Terminology

Charitable Lead Trust – A trust established in connection with a split-interest agreement, in which the not-for-profit organization receives distributions during the agreement's term. Upon termination of the trust, the remainder of the trust assets is paid to the donor or to third-party beneficiaries designated by the donor.

Charitable Remainder Trust – A trust established in connection with a split-interest agreement, in which the donor or a third-party beneficiary receives specified distributions during the agreement's term. Upon termination of the trust, a not-for-profit organization receives the assets remaining in the trust.

Collections – Works of art, historical treasures, or similar assets that are (a) held for public exhibition, education, or research in furtherance of public service rather than financial gain, (b) protected, kept unencumbered, cared for, and preserved, and (c) subject to an organizational policy that requires the proceeds of items that are sold to be used to acquire other items for collections.

Conditional Promise to Give – A promise to give that depends on the occurrence of a specified future and uncertain event to bind the promisor.

Contribution – An unconditional transfer of cash or other assets to an entity or a settlement or cancellation of its liabilities in a voluntary nonreciprocal transfer by another entity acting other than as an owner.

Costs of Joint Activities – Costs of joint activities are costs incurred for a joint activity. Costs of joint activities may include joint costs and costs other than joint costs. Costs other than joint costs are costs that are identifiable with a particular function, such as program, fundraising, management and general, and membership development costs.

Donor-Imposed Restriction – A donor stipulation that specifies a use for the contributed asset that is more specific than broad limits resulting from the nature of the organization, the environment in which it operates, and the purposes specified in its articles of incorporation or bylaws, or comparable documents for an unincorporated association. A restriction on an organization's use of the asset contributed may be temporary or permanent.

Functional Classification – A method of grouping expenses according to the purpose for which the costs are incurred. The primary functional classifications are program services and supporting activities.

Joint Activity – A joint activity is an activity that is part of the fundraising function and has elements of one or more other functions, such as programs, management and general, membership development, or any other functional category used by the entity.

Joint Costs – Joint costs are the costs of conducting joint activities that are not identifiable with a particular component of the activity.

Natural Expense Classification – A method of grouping expenses according to the kinds of economic benefits received in incurring those expenses. Examples of natural expense classifications include salaries and wages, employee benefits, supplies, rent, and utilities.

Permanently Restricted Net Assets – The part of the net assets of a not-for-profit organization resulting (a) from contributions and other inflows of assets whose use by the organization is limited by donor-imposed stipulations that neither expire by passage of time nor can be fulfilled or otherwise removed by actions of the organization, (b) from other asset enhancements and diminishments subject to

the same kinds of stipulations, and (c) from reclassifications from (or to) other classes of net assets as a consequence of donor-imposed stipulations.

Promise to Give – A written or oral agreement to contribute cash or other assets to another entity. A promise to give may be either conditional or unconditional.

Temporarily Restricted Net Assets – The part of the net assets of a not-for-profit organization resulting (a) from contributions and other inflows of assets whose use by the organization is limited by donor-imposed stipulations that either expire by the passage of time or can be fulfilled and removed by actions of the organization pursuant to those stipulations, (b) from other asset enhancements and diminishments subject to the same kinds of stipulations, and (c) from reclassifications to (or from) other classes of net assets as a consequence of donor-imposed stipulations, their expiration by passage of time, or their fulfillment and removal by actions of the organization pursuant to those stipulations.

Unrestricted Net Assets – The part of net assets of a not-for-profit organization that is neither permanently restricted nor temporarily restricted by donor-imposed stipulations.

Single Audit &Yellow Book Terminology

Attestation Engagements – Attestation engagements concern examining, reviewing, or performing agreed-upon procedures on a subject matter or an assertion about a subject matter and reporting on the results.

Compliance Supplement – A document issued annually in the Spring by the OMB to provide guidance to auditors.

Data Collection Form – A form submitted to the Federal Audit Clearinghouse which provides information about the auditor, the auditee and its federal programs, and the results of the audit.

Federal Financial Assistance – Assistance that non-federal entities receive or administer in the form of grants, loans, loan guarantees, property, cooperative agreements, interest subsidies, insurance, food commodities, direct appropriations, or other assistance, but does not include amounts received as reimbursement for services rendered to individuals in accordance with guidance issued by the Director.

Financial Audits – Financial audits are primarily concerned with providing reasonable assurance about whether financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles (GAAP) or with a comprehensive basis of accounting other than GAAP.

GAGAS – Generally Accepted Government Auditing Standards issued by the GAO. They are also commonly known as the Yellow Book.

GAO – The United States Government Accountability Office. Among their responsibilities is the issuance of Generally Accepted Government Auditing Standards (a.k.a. the Yellow Book).

OMB – The Office of Management and Budget. OMB assists the President in the development and implementation of budget, program, management, and regulatory policies.

Pass-Through Entity – A non-federal entity that provides federal awards to a subrecipient to carry out a federal program.

Performance Audits – Performance audits entail an objective and systematic examination of evidence to provide an independent assessment of the performance and management of a program against objective criteria as well as assessments that provide a prospective focus or that synthesize information on best practices or cross-cutting issues.

Program-Specific Audit – An audit of one federal program.

Single Audit – An audit of a non-federal entity that includes the entity's financial statements and Federal awards.

Single Audit Guide – This AICPA Audit Guide formally titled Government Auditing Standards and Circular A-133 Audits (the Single Audit Guide) is the former Statement of Position (SOP) 98-3. The Single Audit Guide provides guidance on the auditor's responsibilities when conducting a single audit or program-specific audit in accordance with the Single Audit Act and Circular A-133.

Subrecipient – A non-federal entity that receives federal awards through another non-federal entity to carry out a federal program, but does not include an individual who receives financial assistance through such awards.

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Yellow Book Financial Audits

By William Blend, CPA, CFE

Solutions

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The AICPA offers a free, daily, e-mailed newsletter covering the day’s top business and financial articles as well as video content, research and analysis concerning CPAs and those who work with the accounting profession. Visit the CPA Letter Daily news box on the www.aicpa.org home page to sign up. You can opt out at any time, and only the AICPA can use your e-mail address or personal information.

Have a technical accounting or auditing question? So did 23,000 other professionals who contacted the AICPA's accounting and auditing Technical Hotline last year. The objectives of the hotline are to enhance members' knowledge and application of professional judgment by providing free, prompt, high-quality technical assistance by phone concerning issues related to: accounting principles and financial reporting; auditing, attestation, compilation and review standards. The team extends this technical assistance to representatives of governmental units. The hotline can be reached at 1-877-242-7212.

SOLUTIONS

CHAPTER 1

Solutions to Knowledge Check Questions

1.

a. Correct. GAGAS does not apply to audits of for-profit organizations.
b. Incorrect. GAGAS applies to audits of government functions.
c. Incorrect. GAGAS applies to audits of government programs.
d. Incorrect. GAGAS applies to audits of government activities.

2.

a. Incorrect. The public interest is defined as the collective well-being of the community of people and entities the auditors serve.
b. Correct. Objectivity includes being independent of mind and appearance when providing audit and attestation engagements.
c. Incorrect. Professional behavior includes the avoidance of conduct that might bring discredit to the auditor's work.
d. Incorrect. Proper use of government information, resources, and position involves using government information, resources, and positions for official purposes and not for the auditor's personal gain, or in a manner contrary to law or the interests of the audited entity.

CHAPTER 2

Solutions to Knowledge Check Questions

1.

a. Incorrect. GAGAS does provide guidance for financial statements prepared in accordance with a special purpose framework.
b. Incorrect. GAGAS does provide guidance for issuing letters for underwriters and certain other requesting parties.
c. Correct. GAGAS does not provide guidance specifically for not-for-profit entities that do not receive federal funds, administer federal funds, and who are not the recipient or subrecipient of grants.
d. Incorrect. GAGAS does provide guidance regarding forming an opinion on single financial statements, specified elements, accounts, or items of a financial statement.

2.

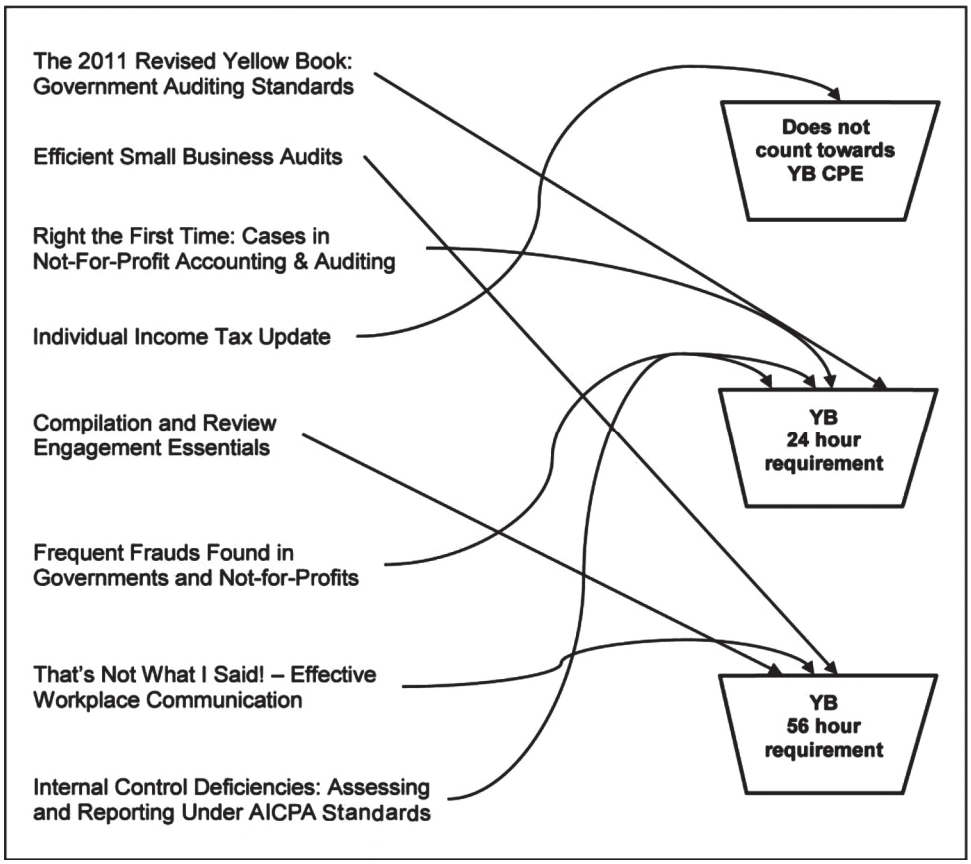
a. Correct. The Yellow Book does not cover compilations.
b. Incorrect. The Yellow Book identifies examinations as a type of attestation engagement covered by GAGAS.
c. Incorrect. The Yellow Book identifies reviews as a type of attestation engagement covered by GAGAS.
d. Incorrect. The Yellow Book identifies agreed-upon procedures as a type of attestation engagement covered by GAGAS.

3.

a. Incorrect. Performance audit objectives may include an assessment of program effectiveness, economy, and efficiency.
b. Incorrect. Performance audit objectives may include an assessment of internal controls.
c. Incorrect. Performance audit objectives may include an assessment of compliance.
d. Correct. A documented review of confidential client information is not included under this topic.

CHAPTER 3

Solution to Exercise 3-1



Solutions to Knowledge Check Questions

1.

a. Incorrect. The auditor could consult with a third party such as a professional organization or another auditor.
b. Incorrect. Another auditor could perform or reperform part of the audit.
c. Incorrect. A professional staff member not involved with the nonaudit service could provide a review of the nonaudit work performed.
d. Correct. Not removing this auditor in a timely manner could cause a threat to independence.

2.

a. Incorrect. Deciding which recommendations of the auditor or third party to implement is considered a management responsibility.
b. Correct. Providing advice to the audited entity on routine business matters is not considered a nonaudit service.
c. Incorrect. Having custody of the audited entity assets is considered a management responsibility.
d. Incorrect. Setting policies and strategic direction for the audited entity is considered a management responsibility.

3.

a. Incorrect. Documentation of threats to independence that require the application of safeguards, along with the safeguards applied, is required.
b. Incorrect. Documentation is required of the safeguards required by GAGAS if an audit organization is structurally located within a government entity and is considered independent based on those safeguards.
c. Correct. Documentation of the consideration of the audited entity management's ability to effectively oversee a nonaudit service is always required when the auditor performs nonaudit services.
d. Incorrect. Documentation is required of the auditor's understanding with an audited entity for which the auditor will perform a nonaudit service.

4.

a. Incorrect. Every 2 years, at least 24 hours of CPE that directly relates to government auditing, the government environment, or the specific or unique environment in which the audited entity operates should be obtained.
b. Incorrect. Auditors described here are required to obtain the stated CPE.
c. Correct. Auditors that are required to take the total 80 hours of CPE should complete at least 20 hours of CPE in each year of the 2-year period.
d. Incorrect. There is a provision that auditors hired or initially assigned to GAGAS audits after the beginning of an audit organization's 2-year CPE period should complete a prorated number of CPE hours.

5.

a. Incorrect. An external peer review is required at least once every three years.
b. Incorrect. There is no special provision in the event of no deficiencies being found.
c. Incorrect. A client requesting a peer review report is not what determines the requirement for obtaining a peer review.
d. Correct. Audit organizations performing GAGAS engagements are required to obtain an external peer review at least once every three years.

6.

a. Incorrect. Fail with deficiencies is not a type of peer review report.
b. Correct. Pass, pass with deficiencies, and fail are all types of peer review reports.
c. Incorrect. Unmodified, qualified, adverse, and disclaimer are not types of peer review reports, they are types of auditor reports.
d. Incorrect. Disclaimer is not a type of peer review report, it is a type of auditor report.

CHAPTER 4

Solution to Exercise 4-1

Cause	1. City officials explained that they were familiar with other grant programs where in-kind payments qualified as grant expenditures. They avowed not having read the fine print requirement for Urban Development Action Grant (UDAG) matching payments to be in cash and only for direct costs. The city officials who signed the grant said the matching requirement was not set forth in the documents they signed but acknowledged that it may have been in 20 or so pages of boilerplate attached to the documents.
Condition	2. The city reported final project costs at $830,000 and city expenditures at $190,000. Review of the city records showed that of the $190,000, ▪ $110,000 was for land and rights-of-way the city already owned; ▪ $60,200 was for all allocated salaries of city staff administering grant construction work that was done on contract; and ▪ $19,800 was for meters and valves the city purchased for the project and provided to the contractor.
Effect	3. The city is required by grant terms to expend $160,000 in matching payments on grant costs. Of the city's reported grant expenditures, only $19,800 qualifies as a matching payment. The difference of $140,200 qualifies as a liability, and this amount is considered material relative to the financial statements.
Condition	4. The city of Zahl was awarded UDAG funding of $800,000 to extend its water and sewer system to a small industrial park. This improvement grant was awarded to attract a wholesale distribution firm that would develop the park and employ up to 100 people. Zahl is located at an intersection of three interstate highways.
Criteria	5. Recipients of UDAG funding are required by law to pay 20 percent of the amount of the awarded grant. This matching 20 percent must be in cash and expended on direct costs of the project.
Condition	6. Zahl is a small city by UDAG criteria, and it meets UDAG criteria as a "distressed" area. The city lost two small manufacturing plants in the past year with a combined employment of 125 people.

Solution to Exercise 4-2

There are many ways to write up a finding. Although your descriptions of the elements very likely will be different than the descriptions noted here, you can see if you captured the essential elements of the finding elements and possible auditor recommendation. Although the auditor does not draft the management response, this is a response that management might provide to the auditor.

Criteria	1. Management of the entity is responsible for complying with laws and regulations. This responsibility includes establishing the necessary internal controls to ensure such compliance.
Condition	2. The entity was provided $100 million to carry out its programs. Program legislation and regulations imposed several requirements on the use of the funds. The entity has not established internal controls to ensure compliance with these requirements.
Effect	3. Substantive audit tests for compliance with the requirements applicable to use of the funds did not reveal instances of noncompliance material to the financial statements. However, due to its significance, we consider this condition to be a material weakness in internal controls.
Cause	4. The entity's management had not undertaken the necessary steps to establish appropriate internal controls to help ensure compliance with laws and regulations.
Recommendation	5. We recommend that the entity officials expedite the establishment and maintenance of the appropriate internal controls to provide reasonable assurance of compliance with laws and regulations.
Management Response	6. The entity officials promised that they would establish and maintain internal controls that would help ensure compliance with laws and regulations.

Solutions to Knowledge Check Questions

1.

a. Correct. Criteria is an element of every finding.
b. Incorrect. Criteria does provide a context for evaluating evidence and understanding the finding.
c. Incorrect. Expected performance may be one criterion for a finding.
d. Incorrect. Laws and regulations may be one criterion for a finding.

2.

a. Incorrect. Information received regarding previous audits and attestation engagements is not used to determine if the auditor should accept the engagement.
b. Incorrect. Information received regarding previous audits and attestation engagements is not used to determine if the auditor should issue an unmodified opinion on the financial statements.
c. Incorrect. Information received regarding previous audits and attestation engagements is not used to evaluate the honesty of audited entity officials.
d. Correct. GAGAS states that the auditor should evaluate whether the entity has taken appropriate corrective action to address findings and recommendations from previous engagements that could have a material effect on the financial statements. This is done using the information received related to previous audits and attestation engagements

3.

a. Incorrect. When presenting finding such as deficiencies in internal control and fraud, the auditors *should* develop the elements of the findings to the extent necessary.
b. Incorrect. The presentation of findings in the auditors' report *should* include deficiencies from the prior year that have not been remediated.
c. Correct. While the auditors are not required to, they *may* provide recommendations for corrective action as part of presenting findings in the auditors' report.
d. Incorrect. Auditors *may* provide recommendations for corrective action as part of presenting findings in the auditors' report when the elements of a finding are sufficiently developed.

4.

a. Incorrect. Significant deficiencies and material weaknesses in internal control should be reported.
b. Incorrect. Instances of noncompliance with provisions of laws and regulations that have a material effect on the financial statements and any other instances that warrant the attention of those charged with governance should be reported.
c. Incorrect. Noncompliance with provisions of contracts and grant agreements that could have a material effect on the determination of financial statement amounts should be reported.
d. Correct. Only fraud that has a material effect on the financial statements and any other instances that warrant the attention of those charged with governance should be reported.

5.

a. Correct. Control deficiency and prevent are the correct terms to complete this technical statement accurately.
b. Incorrect. A control deficiency of any kind, not just a material weakness, may be communicated early. The purpose of this is to prevent, not just evaluate, further noncompliance.
c. Incorrect. The objective of early communication of control deficiencies is so that the auditee can take corrective action to prevent further noncompliance.
d. Incorrect. While early communication of a material weakness may allow the entity to take corrective action to prevent further noncompliance, other types of control deficiencies may also be communicated early.

6.

a. Incorrect. These instances of noncompliance with provisions of contracts or grant agreements would be included in the report on internal control and compliance and should be included in the entity's views of responsible officials.
b. Incorrect. Significant deficiencies would be included in the report on internal control and compliance and should be included in the entity's views of responsible officials.
c. Correct. Control deficiencies would not be included in the report on internal control and compliance and therefore would not be included in the entity's views of responsible officials.
d. Incorrect. Material weaknesses would be included in the report on internal control and compliance and should be included in the entity's views of responsible officials.

CHAPTER 5

Solution to Exercise 5-1

What Cost Principles Apply to this Award?		
Federal Award Funding Period	**Cost Principles Applicable to Award**	
	Circular A-133	**Uniform Guidance**
01/01/14–12/31/14	√	
07/01/14–06/30/15	√	
Funding increment action dated 03/01/15 based on award with original award date of 03/01/13 (award terms and conditions modified)		√
01/01/15-12/31/15		√
Funding increment action dated 09/01/15 based on award with original award date of 09/01/14 (no change to award terms and conditions)	√	

Solutions to Knowledge Check Questions

1.

a. Incorrect. The Uniform Guidance contains Subpart B, *General Provisions*.
b. Incorrect. The Uniform Guidance contains Subpart D, *Post Federal Award Requirements*.
c. Correct. The Uniform Guidance does not contain a Subpart G, *Hospital Cost Principles*. (Hospital cost principles have not yet been revised.)
d. Incorrect. The Uniform Guidance contains Subpart E, *Cost Principles*.

2.

a. Incorrect. The definitions of the terms "must" and "should" in the Uniform Guidance are not the same as those definitions in GAAS.
b. Incorrect. The Uniform Guidance defines the terms "must" and "should" differently than is found in both GAAS and GAGAS.
c. Correct. The definitions of the terms "must" and "should" are different than is found in both GAAS and GAGAS.
d. Incorrect. This statement is not true because the definitions of the terms "must" and "should" are the same in both GAAS and GAGAS.

3.

a. Incorrect. A nonfederal entity that expends $750,000 or more in federal awards during the entity's fiscal year is required to have a single audit. $500,000 is the threshold under Circular A-133.
b. Incorrect. A nonfederal entity that expends $750,000 (not $1,000,000) or more in federal awards during the entity's fiscal year must have a single audit.
c. Correct. A nonfederal entity that expends $750,000 or more in federal awards during the entity's fiscal year is required to have a single audit.
d. Incorrect. A nonfederal entity is required to have a single audit if it expends $750,000 or more in federal awards during the entity's fiscal year.

4.

a. Incorrect. The Uniform Guidance states that a nonfederal entity should be in compliance with either the Green Book or COSO. The use of the term "should" indicates that this is a best practice, not a requirement.
b. Correct. A nonfederal entity should be in compliance with either the Green Book or COSO. This is not a requirement, but a best practice.
c. Incorrect. The Uniform Guidance does not require COSO (or the Green Book) to be used. Use of either of these frameworks is a best practice.
d. Incorrect. Type of entity is not a factor when a nonfederal entity is deciding which framework to comply with. It is a best practice that a nonfederal entity be in compliance with either the Green Book or COSO.

5.

a. Incorrect. The 2014 and prior Compliance Supplements listed 14 types of compliance requirements. This has been reduced to 12 types of compliance requirements starting with the 2015 Compliance Supplement.
b. Incorrect. The Compliance Supplement lists 12, not 11, types of compliance requirements for the auditor to consider.
c. Incorrect. The number of the types of compliance requirements in the Compliance Supplement is 12, not 10.
d. Correct. There are 12 types of compliance requirements in the Compliance Supplement.

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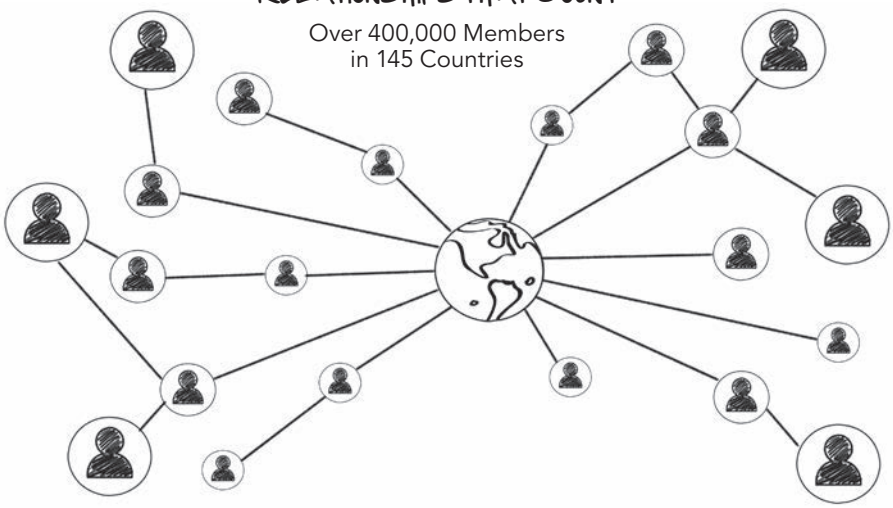

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