Financial Audit Manual

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To Audit Officials, Federal Entity Chief Financial Officers, and Others Interested in Federal Financial Auditing and Reporting

This letter transmits the U.S. Government Accountability Office (GAO) and the Council of the Inspectors General on Integrity and Efficiency's (CIGIE) revised *Financial Audit Manual* (FAM), volumes 1 and 2. The FAM presents a methodology for performing financial statement audits of federal entities in accordance with professional standards and consists of three volumes. FAM volume 1 contains the audit methodology. FAM volume 2 provides detailed implementation guidance. FAM volume 3 contains the Federal Financial Reporting Checklist, which is issued separately.

The current revision reflects changes in auditing financial statements of federal entities since the last revision of FAM volumes 1 and 2 in May 2023. The revisions are primarily based on changes in (1) professional auditing standards of the Auditing Standards Board of the American Institute of Certified Public Accountants (Statements on Auditing Standards Nos. 143, 144, 145, and 147) and (2) audit guidance in the Office of Management and Budget's Bulletin No. 24-01, *Audit Requirements for Federal Financial Statements*, issued on October 19, 2023. Users should also consider any subsequently issued standards or guidance.

To ensure that the FAM continues to meet the needs of the federal audit community and the public it serves, GAO and CIGIE worked jointly to update the FAM. In June 2024, CIGIE distributed an exposure draft of FAM volumes 1 and 2 for a comment period that ended June 12, 2024. All comments we received were considered in the final FAM.

This revision supersedes previously issued versions of FAM volumes 1 and 2 and should be used beginning with audits of fiscal year 2024 federal entity financial statements.

Should you need additional information, please contact us at fam@gao.gov.

Beryl H. Davis
Managing Director
Financial Management and Assurance
U.S. Government Accountability Office

Hannibal "Mike" Ware
Chair, Audit Committee
Council of the Inspectors General on Integrity and Efficiency

Enclosures

GAO Team

Project Team

Robert F. Dacey, Chief Accountant
Dawn B. Simpson, Director
Carrie J. Morrison, Assistant Director
Lien T. To, Senior Auditor

Beryl H. Davis, Managing Director

Significant Contributors

Joshua Marcus, Assistant Director
Caroline Anders, Senior Auditor
Candace Halim, Senior Auditor
Robert Mabasa, Senior Auditor
Seong Bin Park, Senior Auditor
Rebecca Riklin, Senior Auditor
Adrienne N. Walker, Senior Auditor
Stephen Duncan, Auditor
Kota Hunt, Auditor
Christian Sullano, Auditor
Isaac White, Auditor

CIGIE

CIGIE Federal Audit Executive Council's Financial Statements Committee
Chaired by Kelly McFadden, U.S. Department of Justice

Financial Statements Committee Contributors

U.S. Agency for International Development
Chinwe Mbanefo

U.S. Department of Agriculture
Richard Schupbach
Laura Siess

U.S. Department of Commerce
Geoffrey Baker
Yvonne Monyei

U.S. Department of the Treasury
Ade Bankole
Shiela Michel
Catherine Yi

U.S. Department of Defense
Andrew Fechhelm
Sam Fontanez-Berrios
Paul Glenn
Jon Kistler
Erin McDonald
Joseph Murphy
Ai On
Coralis Rodriguez
Theodore Turner
Beth Walton
Jared Winn

Summary of Significant Changes

This summary lists significant changes from the May 2023 revision of FAM volume 1.

Change description	Section or paragraph reference
Clarified the reviewer's involvement in an engagement.	Throughout
Replaced "relevant assertion" with "significant assertion." Deleted "relevant" from "relevant assertion level."	Throughout
Replaced "accounting system" with "financial management system."	Throughout
Deleted "accounting application" or replaced it with "class of transactions."	Throughout
Replaced "classes of transactions, account balances, and note disclosures" or any variation thereof with "line items, accounts, note disclosures, and classes of transactions." Replaced "significant" with "material" when referring to these items.	Throughout
Deleted reference to technical accounting and auditing expert.	110.29
Based on Statement on Auditing Standards (SAS) No. 145, *Understanding the Entity and Its Environment and Assessing the Risk of Material Misstatement*,	
• revised and added requirements and guidance for identifying and assessing the risks of material misstatement due to fraud or error at the financial statement and assertion levels;	210.04–.06; 265 370.06–.10, .15 395 B; 530.02
• revised and added requirements and guidance for obtaining an understanding of the entity and its environment, the applicable financial reporting framework, and the effects of inherent risk factors;	220
• revised and added requirements and guidance for obtaining an understanding of the entity's internal control and the effects of information technology on internal control;	260, 340.07
• added requirement to separately assess inherent risk and guidance for responding to that assessment;	265.22–.26, 470.01–.03
• revised definition for significant risk and revised guidance for identifying and responding to significant risks;	265.27–.32, 470.02
• added requirements for evaluating audit evidence obtained from risk assessment procedures; and	265.56–.57
• revised the specific control evaluation worksheet, line item risk analysis form, and related instructions.	395 G, 395 H
Added requirements and guidance based on SAS No. 147, *Inquiries of the Predecessor Auditor Regarding Fraud and Noncompliance With Laws and Regulations*.	215.11–.13
Revised items 3 and 4 in the Management's Responsibilities section, and deleted "[and OMB audit guidance, if applicable]" in the Auditor's Responsibilities section, of sample audit engagement letter, example 1.	215 A

Change description	Section or paragraph reference
Revised and added requirements and guidance based on SAS No. 143, *Auditing Accounting Estimates and Related Disclosures*.	220.14 260.10, .13, .15, .24 265.27, .34–.36 340.04, 390.06 490.06f 550.18a, 560.06
Renamed section 235, deleted section 240, split section 260 into two sections (260 and 265), and reorganized paragraphs within these sections.	235, 240, 260, 265
Revised section 235 to incorporate guidance for identifying material line items, accounts, note disclosures, and classes of transactions; applicable assertions; and significant financial management systems.	235
Added guidance related to classes of transactions.	235.02 330.03–.04, 395 A
Revised descriptions for the five components of internal control.	260.03
Clarified guidance related to audit risk.	265.01
Clarified and streamlined guidance related to information system controls.	270, 295 F.01 350.13b, 360.11
Revised documentation requirements.	290; 390 490.02, 06a, .06f 590.06q, .06y
Revised definition and use of “relevant controls” and “relevant control activities.” Deleted “key” or replaced it with “relevant” when referring to controls or control activities.	295 B.21 300 450, 495 D
Revised guidance related to testing controls in the roll-forward period and testing of partial-year controls.	295 D.02 350.25, 380 420.09; 495 C.04, C.07
Clarified that control tests should be performed if controls are effectively designed and implemented.	450.01
Added guidance for conducting data reliability tests on sample populations.	310.03, 450.05, 480.01 490.06, 495 D
Revised guidance for identifying relevant control activities and determining whether they have been implemented.	310.09, .11 350.04–.13
Revised guidance for identifying financial reporting control objectives and related control activities.	330.02–.07 340, 395 B
Revised guidance for testing controls related to the control environment, entity risk assessment, information and communication, and monitoring components	360.19
Reiterated the requirement that when the audit approach for a significant risk consists only of substantive tests, the auditor should not place complete reliance on substantive analytical procedures.	470.08 475.05 495 A.04
Revised examples of audit documentation for attribute sampling, monetary unit sampling (MUS), and classical variables sampling.	495 D

Change description	Section or paragraph reference
Revised guidance for evaluating the effects of misstatements on the financial statements and auditor's reports and communicating with those charged with governance related to those misstatements.	540 550.18d
Replaced "risk of material misstatement" with "audit exposure" in the further evaluation of audit risk template. Revised section IV of this template and guidance related to consideration of other factors.	545 A.20 545 A template
Clarified the audit procedures required when there is doubt about the reliability of management's representations or when management does not provide the requested representations.	550.11–.14
Added "a section on" before "required supplementary information" and "other information" in the introductory paragraph of the auditor's report examples. Revised the Other Information section of these examples to include section titles of other information included in the annual report.	595 A 595 B
Revised guidance and examples for the list of adjusting entries needed to correct the uncorrected misstatements, summary of uncorrected misstatements, and summary of corrected misstatements.	595 C
Revised or added definitions or terminology for accounting estimate, assertions, audit risk, auditor's point estimate or auditor's range, balance sheet approach (formerly iron curtain approach), class of transactions, commitment, complementary user entity controls, confidence interval, control activities, control environment, control objective, control risk, cycle, cycle matrix, degree of compliance (should), entity profile, entity risk assessment, fraud risk, fund balance with Treasury, identified risk of material misstatement at the assertion level, identified risk of material misstatement at the financial statement level, information and communication, inherent risk, inherent risk factors, internal control, internal control system, line item risk analysis, management's point estimate, monitoring, net cost approach (formerly rollover approach), reasonably possible, relevant controls or relevant control activities, remote, reviewer (engagement quality control reviewer or second partner), risk assessment procedures, significant assertion, significant risk, and specific control evaluation.	Glossary
Added abbreviations BETC, CARS, SUM, and TAS. Revised descriptions for abbreviations AT-C and AU-C.	Abbreviations

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ABBREVIATIONS

SECTION 100

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110 – Overview of the FAM Methodology

.01 This introduction provides an overview of the methodology of the Government Accountability Office (GAO) and the Council of the Inspectors General on Integrity and Efficiency (CIGIE) for performing financial statement audits of federal entities. It describes how the methodology in the *Financial Audit Manual* (FAM) relates to relevant professional auditing and attestation standards and Office of Management and Budget (OMB) audit guidance and outlines key issues to be considered in using the methodology.[1]

.02 The purposes of performing financial statement audits of federal entities include

- providing decision makers (financial statement users) with assurance as to whether the financial statements are reliable (presented fairly in all material respects, in accordance with U.S. generally accepted accounting principles (U.S. GAAP));[2]
- reporting deficiencies in internal control over financial reporting or, in certain circumstances, providing an opinion on the effectiveness of internal control over financial reporting; and
- reporting on noncompliance with significant provisions of applicable laws, regulations, contracts, and grant agreements (see FAM 245 for guidance on identifying such provisions).

To achieve these purposes, the FAM approach to federal financial statement audits involves four phases—planning, internal control, testing, and reporting—which are outlined in the rest of this section. In broad terms, the auditor does the following:

- adequately plans the audit to obtain sufficient appropriate evidence;
- understands the design of the entity's internal control, determines whether the controls were implemented as designed, assesses the risks of material misstatement, designs appropriate tests of controls and substantive procedures, and for the 24 Chief Financial Officers Act of 1990 (CFO Act) agencies, determines whether financial management

[1]The OMB audit guidance in effect as of the publication date of this version of the FAM is OMB Bulletin No. 24-01, *Audit Requirements for Federal Financial Statements,* issued on October 19, 2023. OMB audit guidance is periodically updated, and the current version can be found on the OMB website at https://www.whitehouse.gov/omb/information-for-agencies/bulletins/ (accessed June 3, 2024).

[2]The American Institute of Certified Public Accountants (AICPA) has recognized the Federal Accounting Standards Advisory Board (FASAB) as the accounting standards-setting body for federal government entities under the AICPA's *Code of Professional Conduct*. Thus, FASAB standards are recognized as U.S. GAAP for federal entities. Statement of Federal Financial Accounting Standards (SFFAS) 34, *The Hierarchy of Generally Accepted Accounting Principles, Including the Application of Standards Issued by the Financial Accounting Standards Board*, establishes the U.S. GAAP hierarchy for federal reporting entities. SFFAS 34 recognizes that it is appropriate for certain federal reporting entities to prepare and publish financial reports pursuant to the accounting and reporting standards issued by the Financial Accounting Standards Board (FASB). SFFAS 34 provides that financial statements prepared in conformity with accounting standards issued by FASB also may be regarded as in conformity with U.S. GAAP for such entities. SFFAS 47, *Reporting Entity,* allows consolidation entities (that is, the consolidated government-wide reporting entity or consolidated component reporting entity) to consolidate component or subcomponent reporting entity financial statements prepared in accordance with FASB under SFFAS 34 without conversion for any differences in accounting policies among the audit organizations.

systems comply substantially with the three requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA):

- federal financial management systems requirements,
- applicable federal accounting standards, and
- the *U.S. Standard General Ledger* at the transaction level;[3]

- tests the significant assertions related to the financial statements, internal control effectiveness, and compliance with significant provisions of applicable laws, regulations, contracts, and grant agreements; and
- reports the results of audit procedures performed and performs other audit procedures to complete the audit in accordance with generally accepted government auditing standards (GAGAS).

The FAM audit phases are illustrated in the FAM methodology overview in the contents and are summarized in the following pages of this section.[4]

Planning Phase

.03 Although planning continues throughout the audit, the objectives of this phase are to gain an understanding of the entity to be audited; to understand its environment, including internal control; to identify significant areas for audit; and to design effective and efficient audit procedures. To accomplish this, the methodology includes guidance in the following:

a. performing preliminary engagement activities relating to (1) acceptance and continuance of client relationships and audit engagements; (2) compliance with relevant ethical requirements; and (3) establishing an understanding of the terms of the engagement with management and, when appropriate, those charged with governance, including establishing that certain preconditions for an audit are present;

b. understanding the entity's operations, including (1) its environment, legal and regulatory framework, accounting policies, use of accounting estimates, and relationships and transactions with disclosure entities, related parties, and public-private partnerships; (2) the applicable financial reporting framework (generally U.S. GAAP);[5] and (3) the effect of inherent risk factors on the preparation of the financial statements.

c. performing analytical procedures to assist in planning the audit;

d. determining materiality for the financial statements as a whole, including performance materiality, which is the portion of materiality that the auditor allocates to line items, accounts, note disclosures, and classes of transactions;

[3]Testing for substantial compliance with FFMIA's three financial management systems requirements is efficiently accomplished, for the most part, as part of the work done in understanding entity systems in the internal control phase of the audit.

[4]The methodology presented is for a financial statement audit. If the auditor is to use the work of another auditor, see FAM 600 sections.

[5]For federal entities, the applicable financial reporting framework is generally U.S. GAAP. See FAM 110.02.

e. identifying material line items, accounts, note disclosures, and classes of transactions, applicable assertions, and significant financial management systems;

f. identifying significant provisions of applicable laws, regulations, contracts, and grant agreements and relevant budget restrictions;

g. understanding the components of internal control, including the effect of information technology on internal control;

h. identifying risks of material misstatement and assessing inherent risk;

i. determining the likelihood of effective information system (IS) controls;

j. identifying relevant operations controls to evaluate and test;

k. planning other audit procedures; and

l. establishing the overall audit strategy and developing an audit plan, including entity field locations to test.

Based on evidence obtained throughout the audit, the auditor should monitor and revise, if needed, preliminary assessments made during the planning phase for risks of material misstatement and the likelihood of control effectiveness. The auditor should revise audit procedures as needed.

Internal Control Phase

.04 This phase entails understanding, testing, and assessing internal control over financial reporting to conclude on whether the following internal control objectives have been achieved:

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

.05 According to OMB audit guidance, for those controls that have been suitably designed and implemented, the auditor should perform sufficient tests of such controls to conclude whether the controls are operating effectively (i.e., sufficient tests of controls to support a low level of assessed control risk). OMB audit guidance does not require the auditor to express an opinion on the effectiveness of internal control.

As required by GAGAS (2018) 6.42, if the auditor does not express an opinion on internal control, the auditor should state in the report whether tests performed provided sufficient, appropriate evidence to express an opinion on the effectiveness of internal control over financial reporting.

GAO auditors[6] should design the audit to express an opinion on internal control over financial reporting.[7] For audits that GAO performs, the internal control testing described in the OMB audit guidance and in the FAM typically is sufficient to provide an opinion on internal control effectiveness. Sufficiency and appropriateness of audit evidence is a matter of auditor judgment.

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

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

.08 The FAM also includes guidance on

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

.09 Also, during the internal control phase, in regard to FFMIA, auditors should follow OMB audit guidance, if applicable.

Testing Phase

.10 The objectives of this phase are to (1) obtain reasonable assurance about whether the financial statements are presented fairly, in all material respects, in accordance with U.S. GAAP; (2) determine whether the entity complied with significant provisions of applicable laws, regulations, contracts, and grant agreements; and (3) assess the effectiveness of internal control over financial reporting through testing controls, often in coordination with other tests.

.11 To achieve these objectives, the FAM includes guidance on

- designing and performing substantive, compliance, and control tests;

[6]The FAM refers specifically to objectives for GAO auditors in various sections. Such objectives are optional for other audit organizations.

[7]If the auditor plans to report on internal control effectiveness, AU-C 940, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements*, allows the auditor to express an opinion directly on internal control or on management's assessment about the effectiveness of internal control over financial reporting. However, when internal control is not effective because one or more material weaknesses exist, the auditor is prohibited from expressing an opinion on management's assessment and should report directly on the effectiveness of internal control over financial reporting. The example 1 auditor's report in FAM 595 A illustrates expressing an opinion on internal control directly.

Although the FAM distinguishes between internal control objectives related to reliability of financial reporting and to compliance with significant provisions of applicable laws, regulations, contracts, and grant agreements, compliance controls tested as part of federal financial statement audits are limited to controls over compliance with selected significant provisions of laws, regulations, contracts, and grant agreements applicable to the entity that have a direct effect on the determination of material amounts and disclosures in the entity's financial statements. Consequently, compliance controls in federal financial statement audits are considered to be the equivalent of financial reporting controls for purposes of reporting on control effectiveness.

- designing and evaluating audit samples;
- correlating risk of material misstatement, audit risk, and materiality with the nature, timing, and extent of substantive procedures; and
- designing multipurpose tests that use a common sample to test several different controls, specific accounts or transactions, and assertions.

Reporting Phase

.12 This phase completes the audit based on the results of audit procedures performed in the preceding phases. This involves developing the auditor's report on the entity's

- financial statements, required supplementary information (RSI) (including management's discussion and analysis (MD&A)), and other information included in the annual report;
- internal control over financial reporting;
- financial management systems' substantial compliance with the three FFMIA requirements (for CFO Act agencies); and
- compliance with significant provisions of applicable laws, regulations, contracts, and grant agreements.

To assist in this process, the FAM includes guidance on forming an opinion on the financial statements and conclusions on internal control, as well as reporting findings. Included in FAM 595 A are two examples of auditor's reports. The first example shows when the auditor expresses an opinion on internal control, and the second when the auditor issues a report on internal control.

Relationship to Applicable Standards

.13 This section describes the FAM's relationship to applicable auditing standards, OMB audit guidance, and other policy requirements. This section is organized into three areas:

- relevant auditing standards and OMB audit guidance,
- audit guidance beyond the *Government Auditing Standards* (also known as GAGAS or the Yellow Book) issued by the Comptroller General of the United States,[8] and
- auditing standards and policies not addressed in this manual.

Relevant Auditing Standards and OMB Audit Guidance

.14 The FAM provides a framework for performing financial statement audits of federal entities in accordance with GAGAS and OMB audit guidance. GAGAS incorporates, by reference, U.S. generally accepted auditing standards (U.S. GAAS) and attestation standards established by the Auditing Standards Board of

[8]GAO, *Government Auditing Standards: 2018 Revision*, GAO-18-568G (Washington, D.C.: July 2018). References to this document are noted as "GAGAS (2018)" in the FAM. There is a 2024 revision to GAGAS that is effective for periods beginning on or after December 15, 2025. Early implementation of this revision is permitted.

the American Institute of Certified Public Accountants (AICPA). The Yellow Book is available at www.gao.gov.

.15 The FAM is an audit methodology that both integrates the requirements of the standards and provides implementation guidance based on practical experience. The FAM is designed to achieve the following:

- **Effective audits**, by considering compliance with GAGAS; significant provisions of applicable laws, regulations, contracts and grant agreements; and OMB audit guidance.
- **Efficient audits**, by focusing audit procedures on areas of higher risk and materiality and by providing an integrated approach designed to gather audit evidence efficiently.
- **Quality control**, through an agreed-upon framework that is documented and that all personnel can follow.
- **Consistency of application**, through a documented methodology.

.16 The FAM supplements GAGAS and OMB audit guidance and includes references to the AICPA's *Auditing Standards [Clarified]* (AU-C) and *Standards for Attestation Engagements [Clarified]* (AT-C). The AICPA standards are incorporated by reference into GAGAS.

Audit Guidance beyond GAGAS

.17 In addition to complying with GAGAS, for audits to which OMB audit guidance applies, the auditor should

- perform sufficient tests of internal controls over financial reporting that have been suitably designed and implemented to support a low level of assessed control risk;
- evaluate and test controls related to budget execution and compliance with selected significant provisions of applicable laws, regulations, contracts, and grant agreements;
- understand the design of the entity's process for complying with 31 U.S.C. § 3512 (c), (d) (commonly known as the Federal Managers' Financial Integrity Act of 1982) and whether the design has been implemented;
- perform tests to report on the entity's financial management systems' substantial compliance with the three FFMIA requirements, as required by OMB audit guidance (for CFO Act agencies);
- test for compliance with significant provisions of applicable laws, regulations, contracts, and grant agreements;

- read the required supplementary information, including management's discussion and analysis, for conformity with Federal Accounting Standards Advisory Board standards and OMB reporting guidance;[9] and
- read the other information for conformity with OMB reporting guidance.

.18 Auditors may design procedures to consider and report whether misstatements and internal control weaknesses could affect the achievement of operations objectives or the accuracy of reports prepared by the entity.

.19 GAO auditors generally should design audits to express an opinion on the entity's internal control over financial reporting. When an auditor is engaged to perform an audit of internal control over financial reporting that is integrated with an audit of financial statements, it is referred to as an integrated audit. AU-C 940, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements*, addresses integrated audits and certain requirements have been included in the FAM, but auditors should refer to AU-C 940 as needed for more detailed guidance.

Auditing Standards and Policies Not Addressed in the Manual

.20 The FAM supplements financial audit standards and policies that GAO and the inspectors general (IG) have adopted. It is not intended to address all standards or policies. For example, report processing is not addressed. Further, IGs may use other methodologies that are equivalent to the FAM for conducting financial statement audits in accordance with GAGAS, including AICPA auditing standards and OMB audit guidance.[10]

.21 Throughout the FAM, there are references to various laws, regulations, OMB audit guidance, and other government requirements that are subject to change periodically. Auditors should monitor any changes and ensure that they are using the most updated versions.

Key Implementation Considerations

.22 In applying the FAM, the auditor considers

- audit objectives;
- exercise of professional judgment and professional skepticism;
- form, content, and extent of audit documentation;
- references to positions;
- using the work of others;
- compliance with the FAM;

[9]The OMB reporting guidance in effect as of the publication date of this version of the FAM is OMB Circular No. A-136, *Financial Reporting Requirements,* issued on May 30, 2024. OMB reporting guidance is updated annually and the current version can be found on the OMB website at https://www.whitehouse.gov/omb/information-for-agencies/circulars/ (accessed June 3, 2024).

[10]Under the Chief Financial Officers Act of 1990 (CFO Act), as amended, an IG may perform the agency's financial statements audit with OIG staff or contract the audit to an independent external auditor (IPA firm). See FAM 670, IG Oversight of Audits Performed by Contracted IPA Firms, for details.

- use of technical terms; and
- reference to sections of the FAM.

These items are discussed in more detail below.

Audit Objectives

.23 For audits of entities not subject to OMB audit guidance, the auditor should evaluate whether to conduct those audits in accordance with OMB audit guidance to achieve the audits' objectives. The FAM generally assumes that the objectives of an audit are to express an opinion on the current-year financial statements as part of a 2-year opinion on comparative financial statements, to issue a report (or opinion) on internal control over financial reporting, and to issue a report on compliance. When these are not the objectives, the auditor uses judgment in applying the FAM guidance. In some circumstances, the auditor may expect to issue a disclaimer on the current-year financial statements because of scope limitations, including the auditability of information. In these circumstances, the auditor may develop a multiyear plan in order to express a future opinion when the financial statements are expected to become auditable.

Exercise of Professional Judgment and Professional Skepticism

.24 The auditor should exercise professional judgment in planning and performing an audit of the financial statements (AU-C 200.18), including in evaluating the quantity and quality of audit evidence, and thus its sufficiency and appropriateness, in determining the audit opinion. Although the auditor may find it necessary to rely on audit evidence that is persuasive rather than conclusive to obtain reasonable assurance, the auditor must not be satisfied with audit evidence that is less than persuasive. The auditor should tailor the guidance in the FAM, if needed, to respond to specific situations encountered during an audit. However, the auditor must, at a minimum, meet professional standards. Proper application of professional judgment and skepticism may result in more extensive audit work than described in the FAM. The auditor should document these decisions.

.25 The auditor should plan and perform an audit with professional skepticism, recognizing that circumstances may exist that cause the financial statements to be materially misstated (AU-C 200.17). The auditor's past experience, or a belief that management and those charged with governance are honest and have integrity, does not relieve the auditor of the need to maintain professional skepticism (AU-C 200.A27 and 240.12). Professional skepticism includes questioning contradictory audit evidence and the reliability of documents and responses to inquiries (AU-C 200.A25). If the auditor believes that a document may have been altered or is not authentic, then the auditor should investigate further (AU-C 240.13).

.26 When exercising judgment, particularly when tailoring FAM guidance, the component auditor should consider the needs of, and consult in a timely manner with, the group auditors who plan to use the work being performed so that the judgments exercised can satisfy the needs of both auditors. For example, group auditors of a consolidated entity (such as the U.S. government or an entire department or entity) are likely to plan to use the work of component auditors of subsidiary entities (such as individual

departments and entities or bureaus and components of departments). This coordination can result in more effective government audits and avoid duplication of effort.

.27 Many aspects of a financial statement audit involve technical judgments. The auditor is responsible for making these judgments. The audit organization should have or contract for personnel with adequate technical expertise to provide technical assistance to the auditor, including the following example areas, as necessary:

a. quantifying materiality for the financial statements as a whole, performance materiality, and using tolerable misstatement in determining the extent of substantive sampling procedures (see FAM 230);

b. identifying and assessing the risks of material misstatement (see FAM 265 and 370);

c. assessing the effectiveness of IS controls (see FAM 270);

d. specifying a minimum level of substantive assurance based on the assessed risk of material misstatement, substantive analytical procedures, and substantive detail tests (see FAM 470, 475, and 480);

e. determining whether selections are statistical samples (representative of, and statistically projectable to, the population), nonstatistical samples (representative of, but not statistically projectable to, the population), or nonstatistical selections (not representative of, and not projectable to, the population) (see FAM 430);

f. using audit sampling methods, such as monetary unit sampling, classical variables estimation sampling, or classical probability proportional to size sampling, for substantive or multipurpose testing (including nonstatistical sampling) (see FAM 480);

g. using audit sampling for control testing, other than attribute sampling, and using the tables in FAM 450 to determine sample size when not performing a multipurpose test;

h. using audit sampling for compliance testing of significant provisions of applicable laws, regulations, contracts, and grant agreements, other than attribute sampling using the tables in FAM 460, to determine sample size when not performing a multipurpose test; and

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

Form, Content, and Extent of Audit Documentation

.28 Each phase of the FAM methodology includes documentation requirements (see FAM 290, 390, 490, and 590). In addition, the auditor should prepare documentation that ensures the following:

- The auditor should prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand (1) the nature, timing, and extent of the audit procedures performed to comply with GAGAS; (2) the results of the audit

procedures performed and the audit evidence obtained; and (3) significant findings or issues arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions (AU-C 230.08).

- In documenting the nature, timing, and extent of audit procedures performed, the auditor should record (a) the identifying characteristics of the specific items or matters tested, (b) who performed the audit work and the date such work was completed, and (c) who reviewed the audit work performed and the date and extent of such review (AU-C 230.09). For GAO, see Financial Audit Practice Memo #6 (Supplemental Financial Audit Manual Guidance Applicable Only to GAO Engagements) for further information on GAO's policies regarding audit documentation and reviews.
- The auditor should prepare audit documentation on a timely basis (AU-C 230.07).
- The auditor should adopt reasonable procedures to maintain the confidentiality of client information (AU-C 230.19), such as physical safeguards over hard copy client information and access restrictions to information systems containing client information.

References to Positions

.29 Various sections of the FAM refer to consultation with audit management, persons with the technical expertise to obtain approval or additional guidance, or both. The auditor should document key consultations. Each audit organization should have written evidence, in the audit documentation or in its audit policy manual, of the specific positions of persons who will perform these functions.

The following are references to positions at GAO; however, descriptions of position responsibilities in relation to the audit are included so that the positions or roles can be identified in other audit organizations. IGs performing audits or using firms to perform audits in accordance with the FAM should clarify and document the positions of the persons that the auditor should consult in various circumstances.

a. The **audit director** (engagement partner or first partner) is responsible for the quality of the financial statement audit and the audit report, reporting to the assistant IG for the audit or, at GAO, to the managing director.

b. The **assistant director** is responsible for the operational conduct of the audit and generally for preparation of the audit report. In public accounting firms, the **audit manager** may have these responsibilities.

c. The **reviewer** (engagement quality control reviewer or second partner) is not part of the engagement team and has sufficient and appropriate experience and authority to objectively evaluate the significant judgments that the engagement team made and the conclusions it reached in formulating the auditor's report. This review must be completed before the audit report is issued and may be conducted at appropriate stages during the engagement to allow significant findings or issues to be promptly identified and resolved to

the reviewer's satisfaction.[11] The FAM includes references to certain documentation that must be provided to the reviewer. The reviewer may request additional documentation as necessary.

d. The **audit sampling specialist** is a statistician or other person the auditor consults for technical expertise in areas such as audit sampling, audit sample evaluation, and selecting entity field locations to test.

e. The **IS controls auditor** has technical expertise in information systems, general controls, application controls, and information security. This person is involved with the planning, directing, or performing of audit procedures related to IS controls.[12]

f. The **information technology specialist** possesses special skills or knowledge in the information technology field that extend beyond the skills and knowledge normally possessed by those working in specialized fields of auditing, such as an IS controls auditor.

g. The **Office of the General Counsel (OGC)** advises the auditor in (1) identifying significant provisions of applicable laws and regulations to test; (2) identifying budget restrictions; and (3) identifying and resolving legal issues encountered during the financial statement audit, such as evaluating potential instances of noncompliance.[13]

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

Using the Work of Others

.30 The auditor should consider whether specialized skills are needed to perform the audit. If specialized skills are needed, the auditor should seek the assistance of a professional possessing such skills, who either may be a member of the auditor's staff or an outside professional. In such circumstances, the auditor should have sufficient knowledge to communicate the objectives of the other professional's work; evaluate whether the specified audit procedures will meet the auditor's objectives; and evaluate the results of the audit procedures applied as they relate to the nature, timing, and extent of

[11]There are a few circumstances identified in the FAM where timely review of audit documentation by the reviewer at appropriate stages during the engagement is required to ensure the effectiveness and efficiency of the audit. Generally, timely manner in this context means after the engagement team makes a judgment or conclusion about an issue and before the judgment or conclusion is implemented or finalized.

[12]App. V of GAO, *Federal Information System Controls Audit Manual (FISCAM)*, GAO-09-232G (Washington, D.C.: February 2009), provides examples of the knowledge, skills, and abilities that an IS controls auditor should possess.

[13]Audit organizations obtain legal counsel in a variety of ways, and each audit organization's OGC size and configuration can vary. In that regard, the designation of OGC in the FAM could include legal counsel in IG offices that employ or hire their own legal counsel as well as the entity's legal counsel.

further planned audit procedures (AU-C 300.12). See FAM 600 for guidance in using the work of others.

Compliance with the FAM

.31 The following terms are used throughout the FAM (all volumes) to describe the degree of compliance:

- **Must:** Compliance is mandatory when the circumstances exist to which the requirement is relevant. Most "musts" indicate unconditional requirements that come directly from professional auditing standards, while other instances of "must" are unique needs for the government environment and, therefore, GAO/CIGIE determined them to be required.
- **Should:** Compliance is mandatory when the circumstances exist to which the requirement is relevant, except in rare circumstances when the specific procedure to be performed would be ineffective in achieving the intent of the requirement (AU-C 200.26). The auditor must document (1) the justification for any departure and (2) how the alternative audit procedures performed were sufficient to achieve the intent of the requirement or policy (AU-C 230.13). The documentation must be provided to the reviewer in a timely manner to allow any issues to be promptly identified and resolved (see FAM 110.29c).[14]
- **Generally should:** Compliance is strongly encouraged when the circumstances exist to which this policy is relevant. The auditor should discuss any departure with the assistant director (or equivalent, such as the audit manager in a public accounting firm) and document such discussions.
- **May, might, could:** These terms are used in the FAM to provide further explanation of and guidance for implementing audit requirements. Compliance is optional. The auditor need not document compliance.

Use of Technical Terms

.32 The FAM uses many existing technical auditing terms and includes a glossary of significant terms at the end of volume I.

Reference to Sections of the FAM

.33 When cited in audit documentation, correspondence, or other communication, "FAM" may precede section or paragraph numbers. For example, this paragraph is referred to as FAM 110.33.

[14]Similar to the AICPA auditing standards, if the FAM states that a procedure or action is one that the auditor should consider, determining whether to perform the procedure or action is required; however, performing the procedure or action is not. Because this is a "should," the auditor should document any reasons for **not** performing this procedure and the alternative procedures performed to meet the objective. When the FAM lists factors that the auditor should evaluate when making a judgment, the auditor is expected to use these factors to make an informed judgment. However, the auditor may also consider other factors.

SECTION 200

Planning Phase

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210 – Overview of the Planning Phase

.01 The objective of the auditor is to plan the audit so that it will be performed in an effective manner (AU-C 300.04). The auditor should develop effective and efficient ways to obtain the sufficient appropriate evidence necessary to report on the entity's

- financial statements, required supplementary information (RSI) (including management's discussion and analysis (MD&A)), and other information included in the annual report;
- internal control over financial reporting;
- financial management systems' substantial compliance with the three requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA) (for CFO Act agencies); and
- compliance with significant provisions of applicable laws, regulations, contracts, and grant agreements.[1]

The nature, extent, and timing of planning vary based on factors, such as the entity's size and complexity, the auditor's experience with the entity, and the auditor's knowledge of entity operations.

.02 The FAM methodology overview in the contents outlines the procedures performed in the planning phase of a financial audit to develop an overall strategy for the audit. The engagement partner and other key members of the engagement team should be involved in planning the audit, including planning and participating in the discussion among engagement team members (AU-C 300.05). The engagement partner may delegate portions of the planning and supervision of the audit to other members of the team (AU-C 300.A4).

.03 In the planning phase, the auditor begins performing risk assessment procedures, which continue through the internal control phase. The risk assessment procedures performed in the planning phase include obtaining an understanding of the entity's operations and internal control, performing preliminary analytical procedures, identifying risks of material misstatement, and assessing inherent risk. The risk assessment procedures discussed in FAM 200 (Planning Phase) and FAM 300 (Internal Control Phase), which includes an assessment of control risk, collectively provide a basis for the design of further audit procedures discussed in FAM 400 (Testing Phase). Before the conclusion of the audit, the auditor evaluates, based on the audit procedures performed and audit evidence obtained, whether the assessments of the risks of material misstatement remain appropriate (see FAM 530 in the Reporting Phase).

.04 The auditor should design and perform risk assessment procedures to obtain audit evidence that provides an appropriate basis for

- the identification and assessment of risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels and

[1]In the FAM, "applicable laws, regulations, contracts, and grant agreements" refers to those laws, regulations, contracts, and grant agreements that are applicable to the audited entity.

- the design of further audit procedures (AU-C 315.13), consisting of control and substantive tests.

The auditor should do so in a manner that is not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory (AU-C 315.13).

.05 Risk assessment procedures should include the following (AU-C 315.14):

- inquiries of management and of other appropriate individuals within the entity, including individuals within the internal audit function (if the function exists);
- analytical procedures; and
- observation and inspection.

.06 In obtaining audit evidence that provides an appropriate basis for risks of material misstatement and further audit procedures, the auditor should consider information from

- the auditor's procedures regarding acceptance or continuance of the client relationship or the audit engagement and
- when applicable, other engagements performed by the engagement partner for the entity (AU-C 315.15).

.07 The auditor should establish an overall audit strategy that sets the scope, timing, and direction of the audit and that guides the development of the audit plan (AU-C 300.07). Although concentrated in the planning phase, planning is an iterative process performed throughout the audit. For example, findings from the internal control phase directly affect planning the substantive audit procedures. Also, the results of control and substantive tests may require changes in the audit strategy or audit plan. Thus, the auditor should update and change the overall audit strategy and audit plan, as necessary, during the course of the audit (AU-C 300.10).

.08 The auditor should consider whether specialized skills are needed in performing the audit. If specialized skills are needed, the auditor should seek the assistance of a professional possessing such skills who either may be a member of the auditor's staff or an outside professional. In such circumstances, the auditor should have sufficient knowledge to communicate the objectives of the other professional's work; evaluate whether the specified audit procedures will meet the auditor's objectives; and evaluate the results of the audit procedures applied as they relate to the nature, timing, and extent of further planned audit procedures (AU-C 300.12). See FAM 620 for guidance on the auditor's use of the work of specialists in an audit. The engagement team and any specialists should, collectively, have the appropriate competence and capabilities to perform the audit in accordance with GAGAS and applicable legal and regulatory requirements, and enable an auditor's report that is appropriate in the circumstances to be issued (AU-C 220A.16).

.09 The auditor should plan the nature, timing, and extent of direction and supervision of engagement team members and review of their work. The nature, timing, and extent of the direction and supervision of the engagement team members and review of their work vary, depending on many factors, including the size and complexity of the entity, the area of the audit (such as fraud and accounting estimates), the assessment of risks of material misstatement, and the

capabilities and competence of the individual team members performing the work (AU-C 300.11 and AU-C 300.A18).

.10 The auditor should consider the needs of, and consult in a timely manner with, other auditors who plan to use the work being performed, especially when exercising significant professional judgment.

215 – Perform Preliminary Engagement Activities

.01 The auditor should undertake the following activities at the beginning of the audit (AU-C 300.06):

a. Perform procedures regarding acceptance and continuance of the client relationships and the audit engagement, as required by AU-C 220A, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*.

b. Evaluate auditor's compliance with relevant ethical requirements in accordance with AU-C 220A and *Government Auditing Standards*, chapter 1, "Foundation and Principles for the Use and Application of Government Auditing Standards."

c. Establish an understanding of the terms of the engagement with management[2] and, when appropriate, those charged with governance,[3] including establishing that certain preconditions for an audit are present, as required by AU-C 210, *Terms of Engagement*.

.02 In the federal environment, the client may include

- the management of the entity to be audited, including senior executives and financial managers;
- the inspector general (IG) if the IG has contracted for the audit;
- the members of a board or commission responsible for the entity;
- the audit committee; or
- a combination of these.

The auditor should identify and document who is the client and those charged with governance for each federal audit. The client and those charged with governance may include multiple entities from this list. See FAM 215.27 for additional guidance on identifying those charged with governance.

.03 For most entities, the Congress (including its committees) has an oversight role, but typically it is not specifically responsible for or involved in overseeing the entity's financial reporting process and is not considered to be part of the entity's internal control. In these circumstances, the Congress (including its committees) is not considered to be part of those charged with governance or an oversight body for purposes of financial statement audits. Auditors should follow their audit

[2]Management refers to the persons with executive responsibility for the conduct of the entity's operations. For some entities, management includes some or all of those charged with governance, for example, senior executives.

[3]Those charged with governance refers to those who have the responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity, including overseeing the entity's financial reporting process. Accordingly, for these purposes, those charged with governance are considered part of the entity's internal control and may be members of a board or commission, an audit committee, the secretary of a cabinet-level department, or senior executives and financial managers responsible for the entity. Although *Standards for Internal Control in the Federal Government* (known as the Green Book) uses "oversight body" (defined as "Those responsible for overseeing management's design, implementation, and operation of an internal control system (paragraph OV2.14)."), the FAM uses "those charged with governance" throughout.

organization's protocols or other policies for communicating with the Congress or its committees. The auditor may decide to include some of the items listed in FAM 550.18 in the communication to the Congress or its committees, but the auditor is not required to communicate these items.

.04 The auditor should communicate with management, those charged with governance, and individuals contracting for or requesting the audit. When auditors perform the audit pursuant to a law or regulation or they conduct the work for the congressional committee that has oversight of the entity, the auditor also should communicate with the congressional committee (GAGAS (2018) 6.06).

.05 Audits may be conducted under various legal authorities. For example, the audit may be

- mandated by law;
- performed under an audit organization's discretionary statutory legal authority;
- performed under contract authority to procure audit services; or
- requested by a congressional committee(s), subcommittee(s), or member(s).

Acceptance and Continuance of Client Relationships and Audit Engagements and Relevant Ethical Requirements

.06 The engagement partner should be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed (AU-C 220A.14). The audit organization establishes these procedures as part of its system of quality control (AICPA Professional Standards, Quality Control Section 10). The engagement partner should also determine that the conclusions reached in performing the procedures are appropriate (AU-C 220A.14). The following information assists the engagement partner in making this determination (AU-C 220A.A7):

- the integrity of the principal owners, key management, and those charged with governance of the entity;
- whether the engagement team is competent to perform the audit engagement and has the necessary capabilities, including time and resources;
- whether the audit organization and the engagement team can comply with relevant ethical requirements (AU-C 200.16); and
- significant findings or issues that have arisen during the current or previous audit engagement and their implications for continuing the relationship.

.07 Relevant ethical requirements are those to which the engagement team and engagement quality control reviewer are subject. These consist of GAGAS, the AICPA *Code of Professional Conduct*, and rules of applicable state boards of accountancy and regulatory agencies (AU-C 220A.09). At the beginning of the engagement, the auditor should evaluate whether the audit organization can comply with the legal and relevant ethical requirements in performing the audit engagement (AU-C 300.06 and QC Section 10.27). Throughout the audit engagement, the engagement partner and other members of the engagement team should remain alert for evidence of noncompliance with relevant ethical

requirements by members of the engagement team (AU-C 220A.11). If matters come to the engagement partner's attention that indicate that members of the engagement team have not complied with relevant ethical requirements, the engagement partner, in consultation with others in the audit organization as appropriate, should determine that appropriate action has been taken (AU-C 220A.12).

.08 The engagement partner should form a conclusion on compliance with independence requirements that apply to the audit engagement by

a. obtaining relevant information from the audit organization and, when applicable, other audit organizations to identify and evaluate circumstances and relationships that create threats to independence;

b. evaluating information on identified breaches, if any, of the audit organization's independence policies and procedures to determine whether they create a threat to independence for the audit; and

c. taking appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards.

The engagement partner should promptly report to the audit organization any inability to resolve the matter so that the organization may take appropriate action. (AU-C 220A.13 and GAGAS (2018) 3.27)

.09 In the federal environment, auditors may be appointed in accordance with law or regulation, and as such, certain of the requirements and considerations regarding the acceptance and continuance of client relationships and audit engagements may not be relevant. Nonetheless, information gathered as a result of the process described may be valuable in planning the audit, performing risk assessments, and carrying out reporting responsibilities (AU-C 220A.A8).

.10 The auditor's consideration of client continuance and relevant ethical requirements, including independence, occurs throughout the audit engagement as conditions and changes in circumstances occur. Performing initial procedures on both client continuance and evaluation of relevant ethical requirements (including independence) at the beginning of the current audit engagement means that they are completed prior to the performance of other significant activities for the current audit engagement. For continuing audit engagements, such initial procedures often begin shortly after (or in connection with) the completion of the previous audit (AU-C 300.A8).

.11 Before accepting an engagement for an initial audit, including a reaudit engagement, when a predecessor auditor exists, the auditor should request that management authorize the predecessor auditor to respond fully to the auditor's inquiries regarding matters that will assist the auditor in determining whether to accept the engagement. If management refuses to authorize the predecessor auditor to respond or limits the response, the auditor should inquire about the reasons and consider the implications of that refusal or limitation in deciding whether to accept the engagement. (AU-C 210.11) If a law or regulation requiring an audit specifically identifies the entities to be audited, in addition to management, the auditor may find it necessary to obtain authorization from those individuals contracting for or requesting the audit and from those legislative committees, if any, that have ongoing oversight responsibilities for the audited entity (AU-C 210.A36).

If management authorizes the predecessor auditor to respond to the auditor's inquiries, the auditor should inquire of the predecessor auditor about matters that will assist the auditor in determining whether to accept the engagement, including

a. identified or suspected fraud involving
   - management,
   - employees who have significant roles in internal control, or
   - others, when the fraud resulted in a material misstatement in the financial statements and

b. matters involving noncompliance or suspected noncompliance with laws, regulations, contracts, or grant agreements that came to the predecessor auditor's attention during the audit, other than when matters are clearly inconsequential (AU-C 210.12).

The communication with the predecessor auditor may be either written or oral (AU-C 210.A32). See AU-C 210.A32 for other matters that may be subject to the auditor's inquiry of the predecessor auditor.

.12 In determining whether to accept the engagement, the auditor should evaluate the predecessor auditor's response or consider the implications if the predecessor auditor provides no response or a limited response (AU-C 210.14). See AU-C 210.13 for the predecessor auditor's responsibilities in responding to the auditor.

.13 The auditor should document the following related to acceptance and continuance of clients and audit engagements and relevant ethical requirements:

a. inquiries of the predecessor auditor and the results of those inquiries, if applicable (AU-C 210.15);

b. conclusions reached regarding acceptance and continuance of the client relationship and audit engagement (AU-C 220A.25c);

c. any issues identified with respect to compliance with relevant ethical requirements and how they were resolved (AU-C 220A.25a), including any threats to independence and the safeguards applied (GAGAS (2018) 3.107a); and

d. conclusions on compliance with independence requirements that apply to the audit engagement and any relevant discussions with the audit organization that support the conclusions (AU-C 220A.25b).

Preconditions for an Audit

.14 To establish whether the preconditions for an audit are present, the auditor should determine whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable (AU-C 210.06a). An applicable financial reporting framework (generally U.S. GAAP) provides the criteria for management to present the financial statements of an entity, including the fair presentation of those financial statements (AU-C 210.A2). The AICPA has designated the Federal Accounting Standards Advisory Board (FASAB) as the source of U.S. generally accepted accounting principles (U.S. GAAP) for federal reporting entities. Effective for periods beginning after September 30, 2017, federal reporting entities, currently defined in Statement of Federal

Financial Accounting Concepts 2, will be defined in Statement of Federal Financial Accounting Standards (SFFAS) 47, *Reporting Entity*. As permitted by SFFAS 34, *The Hierarchy of Generally Accepted Accounting Principles, Including the Application of Standards Issued by the Financial Accounting Standards Board*, some federal entities, including government corporations, prepare financial statements in accordance with standards promulgated by the Financial Accounting Standards Board (FASB). For further information on the requirements for applying the FASB standards, see SFFAS 34.

Factors that are relevant to the auditor's determination of the acceptability of the financial reporting framework to be applied in the preparation of the financial statements include the following (AU-C 210.A4):

- the nature of the entity (for example, whether it is a business enterprise, a governmental entity, or a not-for-profit organization);
- the purpose of the financial statements (for example, whether they are prepared to meet the common financial information needs of a wide range of users);
- the nature of the financial statements (for example, whether the financial statement are a complete set of financial statements or a single financial statement); and
- whether law or regulation prescribes the applicable financial reporting framework (generally U.S. GAAP).

.15 Additionally, the auditor should obtain the agreement of management that it acknowledges and understands its responsibilities in a financial statement audit, including responsibility for

- the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework (generally U.S. GAAP);
- the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error (AU-C 210.06b); and
- compliance with provisions of laws, regulations, contracts, and grant agreements applicable to the entity.

The auditor should also obtain the agreement of management that it acknowledges and understands its responsibility to provide the auditor with

- access to all information of which management is aware that is relevant to the preparation and fair presentation of the financial statements, such as records, documentation, and other matters;
- additional information that the auditor may request from management for the purpose of the audit; and
- unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence (AU-C 210.06b).

The example audit engagement letters in FAM 215 A include these and other management responsibilities.

.16 Management's agreement should be in writing and may be incorporated as part of the audit engagement letter, as shown in the examples in FAM 215 A (AU-C 210.10 and .A44). This agreement should generally be obtained from the same officials whom the auditor will ask to sign the management representation letter.

.17 If the preconditions for an audit, as discussed in FAM 215.14 through .15, are not present, the auditor should discuss the matter with management. If the preconditions for an audit have not been met, the auditor should not accept the proposed audit engagement, unless required by law or regulation to do so (AU-C 210.08). For federal financial statement audits, executive branch departments, agencies, and other entities are required to prepare audited financial statements under such laws as the CFO Act, the Government Management Reform Act of 1994, or the Accountability of Tax Dollars Act of 2002. Government corporations are required to prepare audited financial statements under the Government Corporation Control Act.

Agreement on the Terms of the Engagement

.18 The auditor should agree upon the terms of the engagement with management, those charged with governance, or both, as appropriate (AU-C 210.09). When the agreement on the terms of the engagement is only with those charged with governance, the auditor is required to obtain management's agreement that it acknowledges and understands its responsibilities (AU-C 210.06 and .A21). The auditor should document the agreed-upon terms in an audit engagement letter or other suitable form of written agreement. The letter or written agreement should include

a. the required elements and wording in AU-C 210.10, related to the objectives and scope;

b. the responsibilities of both management and the auditor;

c. a statement that because of the inherent limitations of an audit and internal control, an unavoidable risk exists that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with GAGAS;

d. identification of the applicable financial reporting framework for the preparation of the financial statements (generally U.S. GAAP); and

e. expected form and content of reports, including a statement that circumstances may arise in which a report may differ from its expected form and content.

Additionally, the letter generally states that the auditor will conduct the audit in accordance with GAGAS, and if applicable, Office of Management and Budget (OMB) audit guidance. Those standards and OMB audit guidance require that the auditor plans and performs the audit to obtain reasonable, rather than absolute, assurance about whether financial statements are free of material misstatement. Examples of an audit engagement letter are provided in FAM 215 A.

.19 At a minimum, an audit includes obtaining an understanding of internal control sufficient for planning the audit and determining the nature, timing, and extent of audit procedures to be performed. Additional procedures may be required related

to testing the effectiveness of internal control if the audit is being conducted under OMB audit guidance or if the auditor is providing an opinion on the effectiveness of internal control over financial reporting. An auditor either expresses an opinion on the effectiveness of internal control over financial reporting or reports on the results of procedures performed, as discussed in FAM 580. The engagement letter or written agreement should include the auditor's responsibilities for testing and reporting on internal control over financial reporting, including whether the auditor plans to express an opinion on the effectiveness of internal control over financial reporting or report on the results of procedures performed.

.20 The engagement letter or written agreement should include the auditor's responsibility for

a. testing and reporting on compliance with significant provisions of laws, regulations, contracts, or grant agreements applicable to the entity and performing other limited procedures;

b. testing and reporting on the entity's financial management systems' substantial compliance with the three Federal Financial Management Improvement Act of 1996 (FFMIA) requirements (for CFO Act agencies); and

c. applying certain limited procedures to any RSI, reading other information and considering whether a material inconsistency exists between the other information and the financial statements, and reporting the results.

.21 The letter may also communicate additional matters, such as the involvement of others and fee and billing arrangements, although these may be addressed in separate contractual documents.

.22 The engagement letter or written agreement is designed to avoid misunderstandings between the entity to be audited, the IG if the audit is contracted out by the IG, and the auditor. Where there is a contract, an engagement letter may be unnecessary if all of the required elements in AU-C 210.10 are included in the contract. If management is not a party to the contract, the auditor should obtain management's agreement with the terms of the engagement, as discussed in FAM 215.18. If both an engagement letter and a contract are prepared, the information that appears in these documents should be consistent.

.23 The engagement letter or written agreement may provide that if management of the entity to be audited does not agree with the terms of the audit reached between the party contracting for the audit and the auditor, as documented in the contract or engagement letter, entity management should promptly notify the auditor. If management does not agree with the terms of the audit, the auditor should promptly inform the party contracting for the audit.

.24 The auditor should not agree to a change in the terms of the audit engagement when no reasonable justification for doing so exists (AU-C 210.17). If, prior to completing the audit engagement, the auditor is requested to change the audit engagement to an engagement for which the auditor obtains a lower level of assurance, the auditor should determine whether reasonable justification for doing so exists (AU-C 210.18). If the terms of the audit engagement are changed, the auditor and management should agree on and document the new

terms of the engagement in an engagement letter or other suitable form of written agreement (AU-C 210.19).

.25 If the auditor concludes that no reasonable justification for a change of the terms of the audit engagement exists and is not permitted by management to continue the original audit engagement, the auditor should refer to AU-C 210.20.

Communicating with Those Charged with Governance

.26 The auditor should communicate clearly with those charged with governance. Clear communication of specific matters required to be communicated is an integral part of every audit. However, the auditor is not required to perform procedures specifically to identify other significant matters to communicate with those charged with governance (AU-C 260.05a and .A3).

.27 The auditor should determine the appropriate persons within the entity's governance structure with whom to communicate (AU-C 260.07). The appropriate persons may vary depending on the matter to be communicated. When the appropriate persons with whom to communicate are not clearly identifiable, the auditor and the engaging party may need to discuss and agree on the relevant persons within the entity's governance structure with whom the auditor will communicate (AU-C 260.A8). In 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, the auditor should document the process followed and conclusions reached for identifying appropriate individuals to receive the required auditor communications.

.28 If the auditor communicates with a subgroup of those charged with governance, such as an audit committee, or with an individual, the auditor should determine whether it also needs to communicate with the governing body (AU-C 260.08). AU-C 260.A10 through .A11 outline matters to consider when making this judgment. When all of those charged with governance are involved with managing the entity, the auditor should be satisfied that communication with person(s) with management responsibilities adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity (AU-C 260.09, .A10, and .A11).

.29 The auditor should communicate to those charged with governance

a. the auditor's responsibilities under GAGAS (see FAM 215.30 and .31);

b. an overview of the planned scope and timing of the audit, including the significant risks identified by the auditor (see FAM 215.32);

c. the nature of planned work and level of assurance provided related to internal control over financial reporting and compliance with significant provisions of applicable laws, regulations, contracts, and grant agreements; and

d. the form, timing, and expected general content of communications.

These matters may be communicated either orally or in writing. The auditor may use the engagement letter, contract, or other written communication, such as the example letter in FAM 215 B, as part of this communication (AU-C 260.10, .11, .15, and .A48). (Note: GAO auditors should use the engagement letter.)

.30 The auditor should communicate with those charged with governance the auditor's responsibilities under GAGAS, including that

a. the auditor is responsible for forming and expressing an opinion about whether the financial statements that have been prepared by management, with the oversight of those charged with governance, are prepared, in all material respects, in conformity with U.S. GAAP and

b. the audit of the financial statements does not relieve management or those charged with governance of their responsibilities (AU-C 260.10).

If the entity includes other information in its annual report, such as in a performance and accountability report (PAR), agency financial report (AFR), or annual management report (AMR), the auditor should communicate with those charged with governance the auditor's responsibility with respect to such other information, the procedures performed relating to the other information, and the results (AU-C 720.15).

.31 The auditor may also communicate to those charged with governance the auditor's responsibilities that were communicated with management, as discussed in FAM 215.18 through .20. Additionally, the auditor may communicate the auditor's responsibility for communicating significant matters as well as the limitations on this responsibility discussed in FAM 215.26 (AU-C 260.A13).

.32 The auditor should communicate with those charged with governance an overview of the planned scope and timing of the audit (AU-C 260.11). However, it is important for the auditor not to compromise the effectiveness of the audit, particularly when some or all of those charged with governance are involved with managing the entity. For example, communicating the nature and timing of detailed audit procedures may reduce the effectiveness of those procedures by making them too predictable. AU-C 260.A19 through .A24 provide guidance on communicating the planned scope and timing of the audit, including additional matters that the auditor may discuss with those charged with governance.

As part of communicating the planned scope and audit timing with those charged with governance, the auditor should communicate the significant risks identified by the auditor (AU-C 260.11). Such communication helps those charged with governance understand those matters and why they were determined to be significant risks. The communication about significant risks may assist those charged with governance in fulfilling their responsibility to oversee the financial reporting process (AU-C 260.A20). See FAM 265.27 for a discussion of significant risks.

.33 The auditor should communicate significant findings and issues from the audit to those charged with governance, as discussed in FAM 550.18 and FAM 580. This communication should be in writing if, in the auditor's professional judgment, oral communication would not be adequate. Matters that arose during the audit that were communicated to those charged with governance and satisfactorily resolved do not need to be included in the communication. Factors that may affect whether to communicate orally or in writing, the extent of detail or summarization in the communication, and the formality of the communication are discussed in AU-C 260.A48 through .A50 (AU-C 260.12, .13, .14, and .16).

.34 Management's communication of these matters to those charged with governance does not relieve the auditor of the responsibility to also communicate

with them. However, communication of these matters by management may affect the form or timing of the auditor's communication (AU-C 260.A2).

.35 The auditor's clear communication of these matters helps establish the basis for effective two-way communication. Matters that may contribute to the effectiveness of two-way communication are included in AU-C 260.A44. As discussed in FAM 550.21, the auditor should evaluate whether the two-way communication between the auditor and those charged with governance has been adequate for the purpose of the audit (AU-C 260.20).

.36 When matters in AU-C 260, *The Auditor's Communication With Those Charged With Governance*, discussed above are communicated in writing, the auditor should describe in the communication the purpose of the auditor's written communication and state that the auditor's written communication is not suitable for any other purpose (AU-C 905.11).

.37 The auditor should communicate with those charged with governance on a timely basis. AU-C 260.A51 through .A52 discuss factors relevant for determining the timing of these communications (AU-C 260.19, .A51, and .A52).

.38 The auditor should document all required communications with those charged with governance. If the communication was oral, the auditor should include in the audit documentation when and to whom communication was made. If the communication was written, the auditor should retain a copy of the communication with the audit documentation. If, as part of its communication to those charged with governance, management communicated some or all of the matters the auditor is required to communicate, and as a result, the auditor did not communicate these matters at the same level of detail as management, the auditor should include a copy or summary of management's communications provided to those charged with governance in the audit documentation (AU-C 260.21).

Intent, Notification, and Commitment Letters

.39 The auditor's internal procedures may provide for additional communication with others in the form of an intent, notification, or commitment letter, as discussed below. The auditor should send intent, notification, or commitment letters as provided by the auditor's protocols. The engagement letter may be able to be used in place of certain of these letters.

.40 An intent letter is used by some auditors to acknowledge a congressional request for any type of work. This letter may include

- acknowledgment of a meeting with congressional staff to understand the request;
- indication of a survey of work or planning phase to understand the entity, identify accounting or auditing issues, and determine the availability and access to books and records, particularly for an initial engagement;
- an estimated completion date for the planning phase;
- the auditor team performing the audit; and
- auditor contact names, phone numbers, and email addresses.

.41 A notification letter is used by some auditors to notify entities of new engagements for any type of work. This letter may include

- the source of work (mandate, request, or auditor's statutory discretionary authority);
- objective(s) of the work;
- entities and locations to be contacted;
- the estimated start date;
- the estimated date of entrance conference;
- the auditor team performing the audit;
- auditor contact names, phone numbers, and email addresses; and
- engagement (job) code or other tracking number.

.42 A commitment letter is used by some auditors, either after a survey of work or the planning phase has been completed, or to confirm a commitment to perform an audit based on a congressional request, mandate, or auditor's statutory discretionary authority for any type of work. This letter may include

- a confirmation of the auditor's commitment to perform work and issue a report;
- an overview of the engagement approach, objective(s), and key aspects of the work, including a separate survey of work or planning phase, if conducted;
- the planned report issuance date;
- the auditor team performing the audit; and
- auditor contact names, phone numbers, and email addresses.

.43 For an agreed-upon procedure engagement, as discussed in FAM 710.04, the auditor may issue an engagement letter unless covered by contract or other written communication. An example letter for agreed-upon procedure engagements is presented in FAM 710 A.

215 A – Sample Audit Engagement Letter

.01 As discussed in FAM 215.18, the engagement letter documents the audit's objectives and scope, the roles and responsibilities of both management and the auditor, and other matters. Example 1 presents a sample audit engagement letter when the auditor plans to provide an opinion on the effectiveness of an entity's internal control. Example 2 presents a sample audit engagement letter when the auditor plans to report on the entity's internal control and will not provide an opinion.

In both sample letters, the audited entity has a fiscal year ending September 30. The auditor should modify the sample letters, as needed, for the specific circumstances of each audit.

Example 1 – Auditor Provides an Opinion on Effectiveness of an Entity's Internal Control over Financial Reporting

[Auditor letterhead]

[Date]

[Address to entity management; those charged with governance; the inspector general if the audit has been contracted out to a certified public accounting firm; or others, such as congressional committees, as appropriate.]

Dear _____:

Pursuant to the **[cite legal or contract authority for audit]**, the **[name of auditor]** will audit, for fiscal year **[20X2[4]]**, the financial statements of the **[full name of the entity (entity abbreviation)]**. The job code for this audit is **[XXXXXX] [non-GAO auditors should omit or modify identifier as appropriate]**. We confirm our acceptance and our understanding of this audit engagement by means of this letter. The objectives and scope of our integrated audits are as follows:

1. Express an opinion on whether [**entity's]** financial statements as of and for the fiscal years ended **[September 30, 20X2, and 20X1]**, are presented fairly, in all material respects, in accordance with U.S. generally accepted accounting principles.
2. Express an opinion on whether **[entity]** maintained, in all material respects, effective internal control over financial reporting as of **[September 30, 20X2]**, based on the criteria established under 31 U.S.C. § 3512 (c), (d), commonly known as the Federal Managers' Financial Integrity Act of 1982 (FMFIA) **[or other appropriate criteria]**.
3. Report on the results of our tests of **[entity's]** compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements for fiscal year **[20X2]**.
4. Report whether **[entity's]** financial management systems comply substantially with the three requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA) as of **[September 30, 20X2]**. **[If applicable]**

Upon completion of our audit, we will issue a written report consistent with these objectives. Circumstances may arise in which our report may differ from its expected form and content based on the results of our audit. Depending on the nature of these circumstances, it may be necessary for us to modify our opinions or add emphasis-of-matter or other-matter paragraphs to our auditor's report.

The purpose of our report[**s**] on compliance with laws, regulations, contracts, and grant agreements **[and financial management systems' substantial compliance with FFMIA requirements, if applicable]** solely will be to describe the scope of our testing of compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements **[and financial management systems' substantial compliance with FFMIA requirements, if applicable]**, and the results of that testing, and not to provide an opinion on compliance with applicable laws, regulations, contracts, and grant agreements **[or on financial management systems' substantial compliance with FFMIA requirements, if applicable]**. Accordingly, our report[**s**] on compliance with laws, regulations, contracts, and grant agreements **[and financial management**

[4]Note to auditor: 20X2 denotes the current year, and 20X1 denotes the prior year, under audit.

systems' substantial compliance with FFMIA requirements, if applicable] will not be suitable for any other purpose.

[Modify the previous paragraph, as shown, if the auditor is engaged to provide an opinion on compliance with applicable laws, regulations, contracts, and grant agreements, or on the entity's financial management systems' substantial compliance with FFMIA.]

Management's Responsibilities

Our audit will be conducted on the basis that **[entity's]** management acknowledges and understands that it has responsibility for the following:

1. The preparation and fair presentation of **[entity's]** financial statements, including related notes, in accordance with U.S. generally accepted accounting principles.
2. Designing, implementing, and maintaining effective internal control over financial reporting relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.
3. Assessing the effectiveness of **[entity's]** internal control over financial reporting based on the criteria established under FMFIA **[or other appropriate criteria]**.
4. Its assessment about the effectiveness of internal control over financial reporting as of **[September 30, 20X2]**. This includes providing management's written representation that it did not use the auditor's procedures performed during the integrated audits as part of the basis for its assessment about the effectiveness of **[entity's]** internal control over financial reporting.
5. Supporting its assessment about the effectiveness of **[entity's]** internal control over financial reporting with sufficient evaluations and documentation.
6. Complying with laws, regulations, contracts, and grant agreements applicable to **[entity]**.
7. Preparing, measuring, and presenting the required supplementary information (RSI) in accordance with prescribed guidelines established in U.S. generally accepted accounting principles.
8. Preparing and presenting other information included in **[entity's] [insert name of annual report, e.g., agency financial report]**, and ensuring the consistency of that information with the audited financial statements and RSI.
9. Designing, implementing, and maintaining effective internal controls to prevent and detect fraud. This includes providing management's written representation that it has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud.
10. Maintaining adequate accounting records, selecting and applying appropriate accounting policies, and safeguarding U.S. government assets related to **[entity's]** operations.
11. **[For entities that conform to FASB standards (see FAM 550.31 and .32)]** Evaluating whether there are conditions or events, considered in the aggregate, that raise substantial doubt about **[entity's]** ability to continue as a going concern for a reasonable period of time.
12. Ensuring that **[entity's]** financial management systems comply substantially with FFMIA requirements **[if applicable]**.

In addition, **[entity's]** management acknowledges and understands that it has the responsibility to provide us with

1. access to all information, such as records, documentation, and other matters, of which management is aware that is relevant to the (1) preparation and fair presentation of the financial statements, including related notes; (2) measurement, preparation, and presentation of the RSI; and (3) preparation and presentation of other information;
2. additional information that we may request from management for the purpose of the audit, including but not limited to
    a. minutes of meetings, or summaries of actions of recent meetings for which minutes have not been prepared, of the **[Board of Directors or other similar bodies of those charged with governance]** and
    b. any communications from the Office of Management and Budget (OMB) or the Department of the Treasury's Bureau of the Fiscal Service concerning noncompliance with, or deficiencies in, financial reporting practices;
3. unrestricted access to and full cooperation of personnel within **[entity]** from whom we determine it necessary to obtain audit evidence; and
4. any reports obtained from **[entity]**'s service organizations.

[Entity] management agrees to communicate to us

1. the discovery of any material misstatement that would affect the fair presentation of its fiscal year **[20X2]** or prior fiscal year's financial statements;
2. any deficiencies in the design or operation of internal control over financial reporting as of **[September 30, 20X2]**, including separately identifying any deficiencies management believes to be significant deficiencies or material weaknesses;[5]
3. a description of fraud or suspected fraud that affects **[entity]** and involves (1) management, (2) employees who have significant roles in internal control over financial reporting, or (3) others when the fraud could have a material effect on the financial statements;
4. any instances of noncompliance or suspected noncompliance with laws, regulations, contracts, and grant agreements applicable to **[entity]** whose effects should be considered when preparing the financial statements;
5. any violations, or potential violations, of the Antideficiency Act for the years ended **[September 30, 20X2, and 20X1]** and through the date of the management representation letter. Potential violations are limited to those that, if true, could have a material effect on the financial statements;

[5]A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness yet important enough to merit attention by those charged with governance. A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis.

6. any known actual or possible litigation, claims, and assessments, including those related to treaties and other international agreements, whose effects should be considered when preparing the financial statements;
7. the identities of **[entity's]** disclosure entities, related parties, and public-private partnerships, and all the relationships and transactions related to them;[6]
8. any events or transactions subsequent to the date of the financial statements, and for which U.S. generally accepted accounting principles require adjustment or disclosure;
9. whether, subsequent to **[September 30, 20X2]**, there were any changes in internal control over financial reporting or other conditions that might significantly affect internal control over financial reporting, including any corrective actions taken with regard to material weaknesses or significant deficiencies; and
10. any planned inclusion of our auditor's reports and the audited financial statements in documents prepared by **[entity]** and to provide a copy of any such documents prior to issuance.

As part of our audit process, we will request from **[entity]** management written confirmation concerning representations made to us in connection with the audit of the financial statements, including internal control over financial reporting; compliance with applicable laws, regulations, contracts, and grant agreements; and other related matters.

[Optional – The auditor may choose to make management aware of other specific required written management representations. Factors to consider include initial audits, changes in senior management, or changes in required representations.]

Definition and Inherent Limitations of Internal Control over Financial Reporting

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel. The objectives of internal control over financial reporting are to provide reasonable assurance that (1) transactions are properly recorded, processed, and summarized to permit the preparation of financial statements in accordance with U.S. generally accepted accounting principles, and assets are safeguarded against loss from unauthorized acquisition, use, or disposition, and (2) transactions are executed in accordance with provisions of applicable laws, including those governing the use of budget authority, regulations, contracts, and grant agreements, noncompliance with which could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct, misstatements due to fraud or error. We also caution that projecting any evaluation of effectiveness to future periods is subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.

Auditor's Responsibilities

We are responsible for conducting our audits in accordance with U.S. generally accepted government auditing standards. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether (1) the financial statements as a whole are free from material misstatement, whether due to fraud or

[6]Note to auditor: Procedures related to disclosure entities and public-private partnerships do not apply to entities issuing financial statements in accordance with FASB accounting standards.

error, and (2) effective internal control over financial reporting was maintained in all material respects. Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit of the financial statements or an audit of internal control over financial reporting conducted in accordance with U.S. generally accepted government auditing standards will always detect a material misstatement or a material weakness when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements, including omissions, are considered to be material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements.[7]

We are required to be independent of **[entity]** and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audits.

In performing an audit of the financial statements and an audit of internal control over financial reporting in accordance with U.S. generally accepted government auditing standards, we will do the following:

1. Exercise professional judgment and maintain professional skepticism throughout the audits.
2. Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements in order to obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion.
3. Obtain an understanding of internal control relevant to the financial statement audit in order to design audit procedures that are appropriate in the circumstances.
4. Obtain an understanding of internal control over financial reporting relevant to the audit of internal control over financial reporting, assess the risks that a material weakness exists, and test and evaluate the design and operating effectiveness of internal control over financial reporting based on the assessed risk. Our audit of internal control will also consider **[entity's]** process for evaluating and reporting on internal control over financial reporting based on criteria established under FMFIA **[or other appropriate criteria]**. We will not evaluate all internal controls relevant to operating objectives as broadly established under FMFIA **[or other appropriate criteria]**, such as those controls relevant to preparing performance information and ensuring efficient operations. We will limit our internal control testing to testing controls over financial reporting. Our internal control testing will be for the purpose of expressing an opinion on whether effective internal control over financial reporting was maintained, in all material respects, as of **[September 30, 20X2]**. Consequently, our audit may not identify all deficiencies in internal control over financial reporting that are less severe than a material weakness.

[7]Note to auditor: Statement of Federal Financial Accounting Concepts (SFFAC) 1 issued by FASAB provides a slightly different definition of materiality. Since SFFACs are nonauthoritative, and in SFFAC 1, the board recognizes differences from the audit definition, the FAM is based on the definition provided in AU-C 200.07.

5. Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the financial statements.
6. Perform other procedures we consider necessary in the circumstances.
7. **[For entities that conform to FASB standards (see FAM 550.31 and .32)]** Conclude, based on the audit evidence obtained, whether there are conditions or events, considered in the aggregate, that raise substantial doubt about **[entity's]** ability to continue as a going concern for a reasonable period of time.

Because of the inherent limitations of an audit, together with the inherent limitations of internal control, an unavoidable risk exists that some material misstatements in the financial statements may not be detected, even though the audit is properly planned and performed in accordance with U.S. generally accepted government auditing standards.

We will communicate all deficiencies of which we become aware. We are responsible for communicating in writing to those charged with governance any significant deficiencies and material weaknesses in internal control that come to our attention as a result of the audit. If we identify deficiencies in **[entity's]** internal control that we do not consider to be material weaknesses or significant deficiencies, we will communicate these matters in writing to management and, where appropriate, will report on them separately.

In accordance with U.S. generally accepted government auditing standards, we are responsible for testing compliance with selected provisions of laws, regulations, contracts, and grant agreements applicable to **[entity]** that have a direct effect on the determination of material amounts in **[entity's]** financial statements and performing certain other limited procedures as part of our audits.[8] We will not test compliance with all laws, regulations, contracts, and grant agreements applicable to **[entity]**. We caution that noncompliance may occur and not be detected by these tests.

We are also responsible for (1) testing and reporting on whether **[entity's]** financial management systems comply substantially with the three FFMIA requirements **[if applicable]** and (2) applying certain limited procedures to any RSI, reading other information included in **[entity's] [insert name of annual report, e.g., agency financial report]** and considering whether a material inconsistency exists between the other information and the financial statements, and reporting the results.

Audit Coordination and Other Matters

To use audit resources efficiently and expedite audit completion, we will work with **[entity]** staff to obtain information needed for the audit. Assistance needed from **[entity]** staff may include preparing schedules or analyses; locating, copying, and providing selected documents; and participating in meetings. We will need draft financial statements, including all information relevant to their preparation and fair presentation, whether obtained from within or outside of the general and subsidiary ledgers (including all information relevant to the preparation and fair presentation of note disclosures), and any other information to be included in **[entity's] [insert name of annual report, e.g., agency financial report]** in sufficient time for us to complete our audit in accordance with the proposed timetable. We will discuss this assistance with **[entity]** staff and arrive at mutually acceptable time frames.

[8]Note to auditor: If applicable, include sentence to add tests of laws and regulations listed in OMB audit guidance that the auditor deems applicable to the financial statements.

We will conduct an entrance conference with **[entity]** staff on **[or by] [date]**. We plan to issue our report on a mutually agreed-upon date. **[Insert any additional details as appropriate regarding report timing.]** We will also provide periodic status reports on our work upon your request. If we encounter problems that will affect the reporting date, we will discuss them with you in a timely manner. We look forward to working with **[entity]** and appreciate its cooperation in working with us to complete the audit in a timely manner.

Pursuant to **[include reference to audit reimbursement authority]**, our audit of **[entity]** is performed on a reimbursable basis. The total cost to perform the fiscal year **[20X2]** audit will depend on the nature of the issues we identify and the amount of staff resources needed to complete the audit. **[Consider including additional details as appropriate for any contracted services to be reimbursed, such as those for information systems controls or specialists.]** We plan to submit a bill to you each month reflecting the actual costs incurred.

This assignment will be conducted under my direction, with assistance from **[name and title of manager]**, who can be reached at **[phone number]** or by email at **[email]**, and **[name and title of site auditor]**, who can be reached at **[phone number]** or by email at **[email]**.

The attached acknowledgment page should be signed by management **[and the addressee, if contracting party is other than management]** and returned to us to indicate your acknowledgment of, and agreement with, the terms and arrangements of our audit of the financial statements and to indicate management's acknowledgment and understanding of our respective responsibilities.

Should this letter not represent your understanding of the nature of this engagement, or should you have any questions or need further information, please contact me at **[phone number]** or by email at **[email]**.

We look forward to a successful engagement.

Sincerely,

[Auditor's name and title]

cc: CFO of **[entity]**
Inspector General of **[entity]**
[Others, as applicable]

Management's Acknowledgment of the Audit Engagement Terms

On behalf of **[entity]** and its management, I acknowledge and agree to the (1) terms and arrangements described above for the audit of **[entity]**'s financial statements, including our respective responsibilities, and (2) auditor's scope of work and related reporting on **[entity]**'s

- financial statements, required supplementary information (including management's discussion and analysis) **[omit if not applicable]**, and other information to be included in **[entity's] [insert name of annual report, e.g., agency financial report] [omit if not applicable]**;
- internal control over financial reporting;
- financial management systems' substantial compliance with the three requirements of the Federal Financial Management Improvement Act of 1996 **[omit if not applicable]**; and
- compliance with laws, regulations, contracts, and grant agreements.

_____ _____

Signature Date

[Name and Title]

_____ _____

Signature Date

[Name and Title]

[NOTE: REQUIRED TO BE SIGNED BY MANAGEMENT. SIGNERS SHOULD GENERALLY BE THE SAME OFFICIALS WHOM THE AUDITOR WILL REQUEST SIGN THE MANAGEMENT REPRESENTATION LETTER. MAY INCLUDE ADDITIONAL PARTIES INVOLVED WITH CONTRACTING FOR THE AUDIT.]

Example 2 – Auditor Does Not Provide an Opinion on Entity's Internal Control over Financial Reporting

[Auditor letterhead]

[Date]

[Address to entity management; those charged with governance; the inspector general if the audit has been contracted out to a certified public accounting firm; or others, such as congressional committees, as appropriate.]

Dear _____:

Pursuant to the **[cite legal or contract authority for audit]**, the **[name of auditor]** will audit, for fiscal year **[20X2[9]]**, the financial statements of the **[full name of the entity (entity abbreviation)]**. The job code for this audit is **[XXXXXX] [non-GAO auditors should omit or modify identifier as appropriate]**. We confirm our acceptance and our understanding of this audit engagement by means of this letter. The objectives and scope of our audits are as follows:

1. Express an opinion on whether **[entity]**'s financial statements as of and for the fiscal years ended **[September 30, 20X2, and 20X1]**, are presented fairly, in all material respects, in accordance with U.S. generally accepted accounting principles.
2. Report any significant deficiencies and material weaknesses in internal control over financial reporting for fiscal year **[20X2]** that come to our attention as a result of the audit.[10]
3. Report on the results of our tests of **[entity's]** compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements for fiscal year **[20X2]**.
4. Report whether **[entity's]** financial management systems comply substantially with the requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA) as of **[September 30, 20X2]**. **[If applicable.]**

Upon completion of our audit, we will issue a written report consistent with these objectives. Circumstances may arise in which our report may differ from its expected form and content based on the results of our audit. Depending on the nature of these circumstances, it may be necessary for us to modify our opinion or add emphasis-of-matter or other-matter paragraphs to our auditor's report.

The purpose of our report**[s]** on internal control and compliance with laws, regulations, contracts, and grant agreements **[and financial management systems' substantial compliance with FFMIA requirements, if applicable]** solely will be to describe the scope of our testing of internal control and compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements **[and FFMIA requirements, if applicable]**, and the results of that testing, and not to provide an

[9]Note to auditor: 20X2 denotes the current year, and 20X1 denotes the prior year, under audit.

[10]A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis.

opinion on the effectiveness of internal control over financial reporting or compliance with applicable laws, regulations, contracts, and grant agreements **[or on financial management systems' substantial compliance with FFMIA requirements, if applicable]**. Accordingly, our report**[s]** on internal control and compliance with laws, regulations, contracts, and grant agreements **[and financial management systems' substantial compliance with FFMIA requirements, if applicable]** will not be suitable for any other purpose.

[Modify the previous paragraph, as shown, if the auditor is engaged to provide an opinion on compliance with applicable laws, regulations, contracts, and grant agreements, or on the entity's financial management systems' substantial compliance with FFMIA.**]**

Management's Responsibilities

Our audit will be conducted on the basis that **[entity's]** management acknowledges and understands that it has responsibility for the following:

1. The preparation and fair presentation of **[entity's]** financial statements, including related notes, in accordance with U.S. generally accepted accounting principles.
2. Designing, implementing, and maintaining effective internal control over financial reporting relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.
3. Complying with laws, regulations, contracts, and grant agreements applicable to **[entity]**.
4. Preparing, measuring, and presenting the required supplementary information (RSI) in accordance with prescribed guidelines established in U.S. generally accepted accounting principles.
5. Preparing and presenting other information included in **[entity's] [insert name of annual report, e.g., agency financial report]**, and ensuring the consistency of that information with the audited financial statements and the RSI.
6. Designing, implementing, and maintaining effective internal controls to prevent and detect fraud. This includes providing management's written representation that it has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud.
7. Maintaining adequate accounting records, selecting and applying appropriate accounting policies, and safeguarding U.S. government assets related to **[entity's]** operations.
8. **[For entities that conform to FASB standards (see FAM 550.31 and .32)]** Evaluating whether there are conditions or events, considered in the aggregate, that raise substantial doubt about **[entity's]** ability to continue as a going concern for a reasonable period of time.
9. Ensuring that **[entity's]** financial management systems comply substantially with FFMIA requirements **[if applicable]**.

In addition, **[entity]**'s management acknowledges and understands that it has the responsibility to provide us with

1. access to all information, such as records, documentation, and other matters, of which management is aware that is relevant to the (1) preparation and fair presentation of the financial statements, including related notes; (2) measurement, preparation, and presentation of the RSI; and (3) preparation and presentation of other information;
2. additional information that we may request from management for the purpose of the audit, including but not limited to
    a. minutes of meetings, or summaries of actions of recent meetings for which minutes have not been prepared, of the **[Board of Directors or other similar bodies of those charged with governance]** and
    b. any communications from the Office of Management and Budget (OMB) or the Department of the Treasury's Bureau of the Fiscal Service concerning noncompliance with, or deficiencies in, financial reporting practices;
3. unrestricted access to and full cooperation of personnel within **[entity]** from whom we determine it necessary to obtain audit evidence; and
4. any reports obtained from **[entity]**'s service organizations.

[Entity] management agrees to communicate to us the following:

1. the discovery of any material misstatement that would affect the fair presentation of its fiscal year **[20X2]** or prior fiscal year's financial statements;
2. any deficiencies in the design or operation of internal control over financial reporting as of **[September 30, 20X2]**, including separately identifying any deficiencies management believes to be significant deficiencies or material weaknesses;
3. a description of fraud or suspected fraud that affects **[entity]** and involves (1) management; (2) employees who have significant roles in internal control over financial reporting, or (3) others when the fraud could have a material effect on the financial statements;
4. any instances of noncompliance or suspected noncompliance with laws, regulations, contracts, and grant agreements applicable to **[entity]** whose effects should be considered when preparing the financial statements;
5. any violations, or potential violations, of the Antideficiency Act for the years ended **[September 30, 20X2, and 20X1]** and through the date of the management representation letter. Potential violations are limited to those that, if true, could have a material effect on the financial statements;
6. any known actual or possible litigation, claims, and assessments, including those related to treaties and other international agreements, whose effects should be considered when preparing the financial statements;
7. the identities of **[entity's]** disclosure entities, related parties, and public-private partnerships, and all the relationships and transactions related to them;[11]
8. any events or transactions subsequent to the date of the financial statements, and for which U.S. generally accepted accounting principles require adjustment or disclosure;

[11]Note to auditor: Procedures related to disclosure entities and public-private partnerships do not apply to entities issuing financial statements in accordance with FASB accounting standards.

9. whether, subsequent to **[September 30, 20X2]**, there were any changes in internal control over financial reporting or other conditions that might significantly affect internal control over financial reporting, including any corrective actions taken with regard to material weaknesses or significant deficiencies; and

10. any planned inclusion of our auditor's reports and the audited financial statements in documents prepared by **[entity]** and to provide a copy of any such documents prior to issuance.

As part of our audit process, we will request from **[entity]** management written confirmation concerning representations made to us in connection with the audit of the financial statements, including internal control over financial reporting; compliance with applicable laws, regulations, contracts, and grant agreements; and other related matters.

[Optional – The auditor may choose to make management aware of other specific required written management representations. Factors to consider include initial audits, changes in senior management, or changes in required representations.]

Definition and Limitations of Internal Control over Financial Reporting

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel. The objectives of internal control over financial reporting are to provide reasonable assurance that (1) transactions are properly recorded, processed, and summarized to permit the preparation of financial statements in accordance with U.S. generally accepted accounting principles, and assets are safeguarded against loss from unauthorized acquisition, use, or disposition, and (2) transactions are executed in accordance with provisions of applicable laws, including those governing the use of budget authority, regulations, contracts, and grant agreements, noncompliance with which could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct, misstatements due to fraud or error.

Auditor's Responsibilities

We are responsible for conducting our audit in accordance with U.S. generally accepted government auditing standards **[and OMB audit guidance, if applicable]**. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to error or fraud. Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit of the financial statements conducted in accordance with U.S. generally accepted government auditing standards will always detect a material misstatement when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements, including omissions, are considered to be material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements.[12]

[12]Note to auditor: Statement of Federal Financial Accounting Concepts (SFFAC) 1 issued by FASAB provides a slightly different definition of materiality. Since SFFACs are nonauthoritative, and in SFFAC 1, the board recognizes differences from the audit definition, the FAM is based on the definition provided in AU-C 200.07.

We are required to be independent of **[entity]** and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audits.

In performing an audit of the financial statements in accordance with U.S. generally accepted government auditing standards, we will do the following:

1. Exercise professional judgment and maintain professional skepticism throughout the audits.
2. Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements in order to obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion.
3. Obtain an understanding of internal control relevant to the financial statement audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. In addition, we will not consider all internal controls relevant to operating objectives as broadly established under 31 U.S.C. § 3512 (c), (d), commonly known as the Federal Managers' Financial Integrity Act of 1982 (FMFIA) **[or other appropriate criteria]**, such as those controls relevant to preparing performance information and ensuring efficient operations. Our internal control work will not necessarily identify all deficiencies in internal control, including those that might be material weaknesses or significant deficiencies.
4. Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the financial statements.
5. Perform other procedures we consider necessary in the circumstances.
6. **[For entities that conform to FASB standards (see FAM 550.31 and .32)]** Conclude, based on the audit evidence obtained, whether there are conditions or events, considered in the aggregate, that raise substantial doubt about **[entity's]** ability to continue as a going concern for a reasonable period of time.

Because of the inherent limitations of an audit, together with the inherent limitations of internal control, an unavoidable risk exists that some material misstatements in the financial statements may not be detected, even though the audit is properly planned and performed in accordance with U.S. generally accepted government auditing standards.

We will communicate all deficiencies in internal control of which we become aware. We are responsible for communicating in writing to those charged with governance any significant deficiencies and material weaknesses in internal control that come to our attention as a result of the audit. Additionally, if we do not identify any material weaknesses during our audit, we will indicate this in our written communication.[13] If we identify deficiencies in **[entity]**'s internal control that we do not consider to be material weaknesses or significant deficiencies, we will communicate these matters in writing to management and, where appropriate, will report on them separately. In addition, if we

[13]Note to auditor: In the event that no material weaknesses were identified during the audit, OMB audit guidance requires the auditor to state, in the report on internal control over financial reporting, that no deficiencies in internal control were identified during the audit that were considered to be material weaknesses.

identify misstatements or new deficiencies, we will communicate them to **[entity]** management on a timely basis.

In accordance with U.S. generally accepted government auditing standards, we are responsible for testing compliance with selected provisions of laws, regulations, contracts, and grant agreements applicable to **[entity]** that have a direct effect on the determination of material amounts in **[entity]**'s financial statements and performing certain other limited procedures as part of our audit. We will not test compliance with all laws, regulations, contracts, and grant agreements applicable to **[entity]**. We caution that noncompliance may occur and not be detected by these tests.

We are also responsible for (1) testing and reporting on whether **[entity]**'s financial management systems comply substantially with the three FFMIA requirements **[if applicable]** and (2) applying certain limited procedures to any RSI, reading other information included in **[entity's] [insert name of annual report, e.g., agency financial report]** and considering whether a material inconsistency exists between the other information and the financial statements, and reporting the results.

Audit Coordination and Other Matters

To use audit resources efficiently and expedite audit completion, we will work with **[entity]** staff to obtain information needed for the audit. Assistance needed from **[entity]** staff may include preparing schedules or analyses; locating, copying, and providing selected documents; and participating in meetings. We will need draft financial statements, including all information relevant to their preparation and fair presentation, whether obtained from within or outside of the general and subsidiary ledgers (including all information relevant to the preparation and fair presentation of note disclosures), and any other information to be included in **[entity's] [insert name of annual report, e.g., agency financial report]** in sufficient time for us to complete our audit in accordance with the proposed timetable. We will discuss this assistance with **[entity]** staff and arrive at mutually acceptable time frames.

We will conduct an entrance conference with **[entity]** staff on **[or by] [date]**. We plan to issue our report on a mutually agreed-upon date. **[Insert any additional details as appropriate regarding report timing.]** We will also provide periodic status reports on our work upon your request. If we encounter problems that will affect the reporting date, we will discuss them with you in a timely manner. We look forward to working with [**entity**] and appreciate its cooperation in working with us to complete the audit in a timely manner.

Pursuant to **[include reference to audit reimbursement authority]**, our audit of **[entity]** is performed on a reimbursable basis. The total cost to perform the fiscal year **[20X2]** audit will depend on the nature of the issues we identify and the amount of staff resources needed to complete the audit. **[Consider including additional details as appropriate for any contracted services to be reimbursed, such as those for information systems controls or specialists.]** We plan to submit a bill to you each month reflecting the actual costs incurred.

This assignment will be conducted under my direction, with assistance from **[name and title of manager]**, who can be reached at **[phone number]** or by email at **[email]**, and **[name and title of site auditor]**, who can be reached at **[phone number]** or by email at **[email]**.

The attached acknowledgment page should be signed by management **[and the addressee, if contracting party is other than management]** and returned to us to indicate your acknowledgment of, and agreement with, the terms and arrangements of

our audit of the financial statements and to indicate management's acknowledgment and understanding of our respective responsibilities.

Should this letter not represent your understanding of the nature of this engagement, or should you have any questions or need further information, please contact me at **[phone number]** or by email at **[email]**.

We look forward to a successful engagement.

Sincerely,

[Auditor's name and title]

cc: CFO of **[entity]**
Inspector General of **[entity]**
[Others, as applicable]

Management's Acknowledgment of the Audit Engagement Terms

On behalf of **[entity]** and its management, I acknowledge and agree to the (1) terms and arrangements described above for the audit of **[entity]**'s financial statements, including our respective responsibilities, and (2) auditor's scope of work and related reporting on **[entity]**'s

- financial statements, required supplementary information (including management's discussion and analysis) **[omit if not applicable]**, and other information to be included in **[entity's] [insert name of annual report, e.g., agency financial report] [omit if not applicable]**;
- internal control over financial reporting;
- financial management systems' substantial compliance with the three requirements of the Federal Financial Management Improvement Act of 1996 **[omit if not applicable]**; and
- compliance with laws, regulations, contracts, and grant agreements.

_____ _____

Signature Date

[Name and Title]

_____ _____

Signature Date

[Name and Title]

[NOTE: REQUIRED TO BE SIGNED BY MANAGEMENT. SIGNERS SHOULD GENERALLY BE THE SAME OFFICIALS WHOM THE AUDITOR WILL REQUEST SIGN THE MANAGEMENT REPRESENTATION LETTER. MAY INCLUDE ADDITIONAL PARTIES INVOLVED WITH CONTRACTING FOR THE AUDIT.]

215 B – Sample Letter to Those Charged with Governance

[Auditor letterhead]

[Date]

[Address to board or commission responsible for the entity, an audit committee, secretary of a cabinet-level department, senior executives and financial managers, or congressional committees in their role as those charged with governance.]

Dear _____:

This letter is to inform you that we will soon begin **[or have recently begun]** our audit of the fiscal year 20X2 financial statements of the **[full name of the entity (entity abbreviation)]**. We **[held or will hold]** an entrance conference with officials of **[entity]** on **[date]**.

[If mandated:] We are responsible for conducting audits of the financial statements of **[entity]** in accordance with **[cite legal or contract authority]**. **[If requested:]** As requested in your letter of **[date] [or as discussed with your staff]**, we will conduct an audit of financial statements of **[entity]**. **[If auditor's statutory authority:]** Under our audit authority **[cite legal or contract authority]**, we will conduct an audit of financial statements of **[entity]**. We plan to issue our report by **[date]**.

A copy of our **[date]** audit engagement letter to **[entity or inspector general]** is attached.[14] This letter explains the nature of the engagement, our responsibilities as auditors, and the responsibilities of **[entity]** management.

We will provide periodic status reports on our work upon your request. We will also notify you when we will provide a draft report to **[entity]** for comment and can provide a copy to you for informational purposes upon your request. Should this letter and the attached engagement letter not represent your understanding of the nature of this engagement, or should you have any questions, please contact me at **[phone number]** or by email at **[address]**, or **[second auditor contact and title]**, at **[phone number]** or by email at **[address]**.

Sincerely,

[Auditor name and title]

Enclosure

[14]Sample engagement letter from FAM 215 A.

220 – Understand the Entity's Operations

.01 Understanding the entity's operations in the planning process enables the auditor to identify, assess, and respond to the risks of material misstatement due to fraud or error and to resolve accounting and auditing problems early in the audit. The auditor should perform risk assessment procedures to obtain an understanding of

a. the following aspects of the entity and its environment:

- the entity's organizational structure, governance, and activities, including the extent to which the entity's activities integrate the use of information technology;
- industry, regulatory, and other external factors; and
- the measures used, internally and externally, to assess the entity's financial performance (AU-C 315.19a);

b. the applicable financial reporting framework (generally U.S. GAAP) and the entity's accounting policies and the reasons for any changes thereto (AU-C 315.19b);

c. how inherent risk factors affect the susceptibility of assertions to misstatements, and the degree to which they do so, in the preparation of the financial statements in accordance with the applicable financial reporting framework (generally U.S. GAAP), based on the understanding obtained in items a and b above (AU-C 315.19c);[15]

d. the legal and regulatory framework applicable to the entity and how the entity is complying with that framework (AU-C 250.12);

e. the entity's use of accounting estimates (AU-C 540.12); and

f. the entity's relationships and transactions with disclosure entities, related parties, and public-private partnerships (AU-C 550.12).[16]

[15]Understanding how inherent risk factors affect the susceptibility of assertions to misstatement may assist the auditor with a preliminary understanding of the likelihood or magnitude of misstatements, which assists the auditor in identifying risks of material misstatement at the assertion level in accordance with FAM 265.11b. Understanding the degree to which inherent risk factors affect susceptibility of assertions to misstatement also assists the auditor in assessing the likelihood and magnitude of a possible misstatement when assessing inherent risk in accordance with FAM 265.22a. (AU-C 315.A95)

[16]Under Federal Accounting Standards Advisory Board (FASAB) standards, organizations are considered to be related parties if the existing relationship or one party to the existing relationship has the ability to exercise significant influence over the other party's policy decisions. In the federal government, there are additional relationships that present risks similar to related parties, as defined by FASAB. These include disclosure entities and public-private partnerships. Consequently, while the AICPA auditing standards address only related parties, the auditor should apply audit procedures required for related parties to disclosure entities and public-private partnerships. Note that FASAB and the Financial Accounting Standards Board (FASB) provide different definitions for related parties. Procedures pertaining to disclosure entities and public-private partnerships do not apply to entities issuing financial statements in accordance with FASB accounting standards.

Entity and Its Environment

.02 The auditor should obtain an understanding of the entity for purposes of planning the audit. Elements include

- origin and history of the entity;
- mission and strategic goals of the entity;
- size and locations of the entity;
- organizational structure of the entity (centralized or decentralized);
- how the entity is financed;
- key members of management;
- the complexity of operations;
- the entity's information technology environment, as discussed in FAM 260, and how it affects the generation of financial statements and the RSI in the annual PAR or AFR; and
- use of service organizations (see FAM 310.11 and FAM 640 for further details on service organizations).

See AU-C 315.A64 through .A90 for additional guidance on obtaining an understanding of the entity and its environment.

.03 The auditor should identify significant internal and external factors that affect the entity's operations.

Internal factors may include

- information technology structure, including the extent to which information system processing is performed externally by a service organization;
- increased workload from new or expanding programs;
- qualifications and competence of key personnel; and
- turnover of key personnel.

External factors may include

- source(s) of funds;
- seasonal fluctuations;
- current political climate; and
- other external factors as discussed in AU-C 315.A82, such as general economic conditions, interest rates, and inflation.

Applicable Financial Reporting Framework and the Entity's Accounting Policies

.04 The auditor should evaluate whether the entity's accounting policies are appropriate and consistent with the applicable financial reporting framework (generally U.S. GAAP) (AU-C 315.20). An understanding of the entity's selection and application of accounting policies, including any changes thereto as well as

the reasons therefor, may encompass such matters as financial reporting standards and laws and regulations that are new to the entity and how the entity will adopt, or comply with, such requirements (AU-C 315.A91).

.05 The auditor should determine whether the entity is required to report any unaudited RSI. This includes information on

- the condition of heritage assets and stewardship land,
- deferred maintenance of federal property, and
- social insurance programs.

See AU-C 315.A91 through .A93 for additional guidance on obtaining an understanding of the applicable financial reporting framework (generally U.S. GAAP) and the entity's accounting policies.

Inherent Risk Factors

.06 Inherent risk factors may affect the susceptibility of assertions to misstatement by influencing the likelihood of occurrence of a misstatement or the magnitude of the misstatement if it were to occur (AU-C 315.A95). Inherent risk factors are characteristics of events or conditions that affect the susceptibility of an assertion to misstatement, whether due to fraud or error, before consideration of control activities.[17] Such factors may be qualitative or quantitative and include complexity, subjectivity, change, uncertainty, susceptibility to noncompliance, or susceptibility to misstatement due to management bias or other fraud risk factors (AU-C 315.12). Fraud risk factors are discussed in FAM 265.

.07 The inherent risk factors discussed below are general in nature and require the auditor's judgment in determining how they affect the auditor's assessment of risks of material misstatement at the assertion level. Because this risk consideration requires auditors to exercise significant audit judgment, it should be performed by experienced audit personnel.

Inherent risk factors incorporate characteristics of an entity, a transaction, an account, or an assertion that exist because of the

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

.08 For each category listed below, FAM 295 A lists characteristics of events or conditions that may affect the susceptibility of assertions to misstatement (i.e., potential inherent risk factors).

a. **Nature of the entity's programs:** The mission or business of an entity includes the implementation of various programs or services. The characteristics of these programs or services affect the entity's susceptibility to errors and fraud and sensitivity to changes in economic conditions. For

[17] In the FAM, control activities include controls within the control environment, entity risk assessment, information and communication, and monitoring components that directly address risks of material misstatement at the assertion level (see FAM 360.19).

example, student loan guarantee programs may be more susceptible to errors and fraud because of loans that third parties issue and service.

b. **Prior history of significant audit adjustments:** Significant audit adjustments identified in previous financial statement audits or other audits often indicate conditions that may allow misstatements to occur. For example, the prior year's audit may have identified the necessity for recording a liability as the result of certain economic conditions. The auditor could then focus on determining whether similar conditions continue to exist.

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

.09 Other inherent risk factors that affect susceptibility of an assertion to misstatement about a line item, account, note disclosure, or class of transactions may include one or both of the following (AU-C 315.A11):[18]

- the quantitative or qualitative significance of the line item, account, note disclosure, or class of transactions and
- the volume or lack of uniformity in the composition of the items to be processed through the class of transactions or account balance or to be reflected in the note disclosure.

See AU-C 315.A275 for additional guidance on inherent risk factors. See AU-C 540.A152 for discussion of inherent risk factors related specifically to accounting estimates.

.10 The auditor may evaluate the implications of these risk factors on related operations controls. For example, inherent risk may be associated with a material liability for loan guarantees because it is subject to significant management judgment. Because of this inherent risk factor, the entity should have strong operations controls to monitor its exposure to losses from loan guarantees. Potential deficiencies in such operations controls could significantly affect the ultimate program cost. Therefore, the auditor may identify operations control deficiencies, including the need for operations controls in a particular area that may be further evaluated, as discussed in FAM 275.

[18]AU-C 315 discusses audit procedures for classes of transactions, account balances, and disclosures. The FAM uses line item to describe an aggregation of account balances. The FAM refers to information in the notes to the financial statements as note disclosures.

.11 The entity's information system is a discrete set of information resources organized for the collection, processing, maintenance, use, sharing, dissemination, or disposition of information. Information systems often involve **information system processing**, which is performed through the use of information technology. Information system processing (or lack thereof) can introduce inherent risk factors not present in a manual financial management system.

.12 The auditor should consider each of the following factors and assess the overall impact of information system processing on inherent risk. The impact of these factors typically would be pervasive in nature and may affect the identification and assessment of risks of material misstatement at the financial statement level. An information system controls auditor (IS controls auditor) may assist the auditor in considering these factors and making this assessment. More detail on assessing risks related to information system processing and related controls is available in FISCAM, and a flowchart of steps is included in FAM 295 J.

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

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

c. **Increased potential for undetected misstatements.** Computers use and store information in electronic form and require less human involvement in processing. This increases the potential for individuals to gain unauthorized access to sensitive information and to alter data without visible evidence. Because of the electronic form, changes to software programs and data may not be readily detectible. Also, users may be less likely to challenge the reliability of computer output than manual reports. As such, management should evaluate security threats, which can be from internal or external sources. External threats are particularly important for entities that depend on telecommunications networks and the internet. Internal threats may come from former or disgruntled employees (Green Book 11.13).[19]

d. **Existence, completeness, and volume of the audit trail.** The audit trail is the evidence that demonstrates how a specific transaction was initiated, processed, recorded, and summarized. For example, the audit trail for a purchase could include a purchase order; a receiving report; an invoice; an invoice register (purchases summarized by day, month, account, or a combination of these); and general ledger postings from the invoice register. Some financial management systems are designed so that the audit trail exists for only a short period (such as in online systems), only in an electronic format, or only in summary form. Also, the information generated may be too voluminous to allow effective manual review. For example, one posting to the

[19]GAO, *Standards for Internal Control in the Federal Government*, GAO-14-704G (Washington, D.C.: September 2014).

general ledger may result from the automated summarization of information from hundreds of locations and thousands of documents.

e. **Nature of information systems hardware and software.** The nature of information systems hardware and software can affect inherent risk, as illustrated below.

- The type of information system processing (online, batch oriented, or distributed) presents different levels of inherent risk. For example, the inherent risk of unauthorized transactions and data entry errors may be greater for online processing than for batch-oriented processing.
- Peripheral access devices or system interfaces can increase inherent risk. For example, internet and dial-up access to a system increase the system's accessibility to additional persons and therefore increase the risk of unauthorized access to computer resources.
- Distributed networks enable multiple computer-processing units to communicate with each other, increasing the risk of unauthorized access to computer resources and possible data alteration. On the other hand, distributed networks may decrease the risk of conflicting computerized data between multiple processing units.
- Software programs developed in-house may have higher inherent risk than vendor-supplied software that has been thoroughly tested and is in general commercial use.
- Because of the nature of information systems hardware and software, management should design control activities to limit user access to information technology through authorization control activities, such as providing a unique user identification or token to authorized users. Management should also design other control activities to promptly update access rights when employees change job functions or leave the entity (Green Book 11.14).

f. **Unusual transactions.** As with manual systems, unusual information system processing transactions increase inherent risk. Programs developed to process such transactions may not be subject to the same procedures as programs developed to process routine transactions.

Legal and Regulatory Framework

.13 The laws, regulations, contracts, and grant agreements applicable to the entity constitute its legal and regulatory framework. The auditor should obtain a general understanding of the framework, such as

- the laws, regulations, contracts, and grant agreements that directly determine the amounts and disclosures in the financial statements and
- other laws, regulations, contracts, and grant agreements that might have a fundamental effect on the entity's operations.

The auditor should also obtain a general understanding of how the entity is complying with the framework, such as

- ensuring and documenting compliance;

- preventing noncompliance; and
- identifying, evaluating, and accounting for litigation, contract, and grant agreement claims, or a combination of these. (AU-C 250.12 and .A8)

Accounting Estimates

.14 For accounting estimates, the auditor should obtain an understanding of the following (AU-C 540.12a–.12d and .12f):

a. the entity's transactions and other events or conditions that may give rise to the need for or changes in accounting estimates to be recognized or disclosed in the financial statements;

b. the requirements of the applicable financial reporting framework related to accounting estimates (generally U.S. GAAP) (including the recognition criteria, measurement bases, and the related presentation and disclosure requirements) and how they apply in the context of the nature and circumstances of the entity and its environment;

c. regulatory factors relevant to the entity's accounting estimates, including, when applicable, regulatory frameworks;

d. the nature of the accounting estimates and related disclosures that the auditor expects to be included in the entity's financial statements, based on the auditor's understanding in items a through c; and

e. how management identifies the need for and applies specialized skills or knowledge related to accounting estimates, including with respect to the use of management's specialists.

See AU-C 540.A19 through .A28 for additional guidance on the procedures discussed above. Additional requirements for accounting estimates are discussed in FAM 260 relating to internal control, FAM 265 relating to risk assessment, FAM 340 relating to control activities, and FAM 905 relating to substantive testing.

Relationships and Transactions with Disclosure Entities, Related Parties, and Public-Private Partnerships

.15 For relationships and transactions with disclosure entities, related parties, and public-private partnerships, the auditor should inquire of management and others within the entity regarding

- the identity of the entity's disclosure entities, related parties, and public-private partnerships, including changes from the prior period;
- the nature of the relationships (including ownership structure) between the entity and these disclosure entities, related parties, and public-private partnerships;
- the business purpose of entering into a transaction with the disclosure entity, related party, or public-private partnership, versus with an unrelated party; and
- whether the entity entered into, modified, or terminated any transactions with these disclosure entities, related parties, and public-private partnerships

during the period and, if so, the type and business purposes of the transactions (AU-C 550.14).

Additional requirements related to disclosure entities, related parties, and public-private partnerships are discussed in FAM 265 relating to risk assessment procedures, FAM 280 relating to sharing of information and maintaining alertness, FAM 340 relating to understanding control activities, FAM 904 relating to substantive testing, and FAM 550 relating to conclusions.

.16 For relationships with **disclosure entities**, the auditor should also inquire of management to obtain an understanding of the

- nature and magnitude of relevant activity with these disclosure entities during the period and
- nature of the entity's financial and nonfinancial risks, potential benefits, and exposure to gains and losses from past or future operations of these disclosure entities.

.17 For relationships with **public-private partnerships**, the auditor should also inquire of management to obtain an understanding of the

- purpose, objective, and rationale for the public-private partnership and the relative benefits/revenues being received in exchange for the entity's monetary or nonmonetary consideration;
- entity's statutory authority for entering into the public-private partnership;
- source and amounts of the funding of the public-private partnership over its expected life;
- operational and financial structure of the public-private partnership, including the entity's rights and responsibilities; and
- contractual risks of loss the entity is undertaking within the public-private partnership.

Sources of the Auditor's Understanding

.18 The auditor may gather planning information through different methods (observation, inspection, interviews, reading policy and procedure manuals, etc.) and from a variety of sources, including

- top-level entity management;
- entity management responsible for significant programs;
- the IG office and internal audit management (including any internal control officer);
- others in the audit organization concerning other completed, planned, or in-progress assignments;
- personnel in the Special Investigator Unit; and
- entity legal representatives.

.19 The auditor may gather information from relevant reports and articles issued by or about the entity, including

- the entity's prior PARs, AFRs, or annual reports;
- other financial information;
- Federal Managers' Financial Integrity Act of 1982 (FMFIA) reports and supporting documentation;[20]
- management or auditor reports about financial management systems' substantial compliance with the three FFMIA requirements (for CFO Act agencies only);
- the entity's budget and related reports on budget execution;
- GAO reports (including those for performance audits);
- IG and internal audit reports (including those for performance audits and other work);
- service organization reports (see FAM 640);
- congressional hearings and reports;
- consultants' reports; and
- material published about the entity in newspapers, magazines, internet sites, and other publications.

.20 Audit documentation from prior-year audits may contain useful information for planning the current-year audit. Based on AU-C 315.16, the auditor should evaluate whether such information remains relevant and reliable for planning the current audit. The auditor should update any prior-year information that is to be used as part of the current-year audit documentation so that it reflects the current-year operations, environment, risks, and so forth.

If a different auditor performed the prior-year audit, the current-year auditor should address the need for access to that audit documentation as part of the current-year audit contract. As discussed in AU-C 510.A7, the extent, if any, to which a predecessor auditor permits access to its audit documentation is a matter of professional judgment.

[20]FMFIA was repealed, but provisions remain codified at 31 U.S.C. § 3512(c), (d). These provisions are still commonly referred to as FMFIA. Because of the common usage of the act's name, the FAM will continue to refer to FMFIA. However, auditors should correctly cite the applicable provisions in their reports. See FAM 595 A.

225 – Perform Preliminary Analytical Procedures

.01 As part of the risk assessment procedures, the auditor should perform preliminary analytical procedures to

- understand the entity's operations, including current-year transactions and events;
- identify inconsistencies, unusual transactions or events, and amounts, ratios, and trends that may indicate risks of material misstatement, including any risks related to fraud (see FAM 265); and
- determine the nature, extent, and timing of further audit procedures to be performed.

.02 There may be situations in which the auditor may not be able to perform preliminary analytical procedures; this often relates to the reliability of comparative information. For example, in a first-year audit, comparative information might be unreliable. Therefore, preliminary analytical procedures may be limited. Additionally, for some accounts, it may be difficult to perform preliminary analytical procedures on an interim basis because of the lack of reliable information until year-end.

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

a. **Develop expectations.** The auditor develops expectations for account balances based on plausible relationships that are reasonably expected to exist. For example, as loan activity increases, the auditor would also expect loans receivable balances to increase. If the loans receivable balances decreased, the auditor should make inquiries to understand why. A decrease could be caused by higher loan payoffs, write-offs, or some other logical reason. However, the decrease could also have occurred because of an error or fraud.

   The financial data used in preliminary analytical procedures generally are summarized at a high level, such as the level of financial statements. If financial statements are not available, the auditor may use trial balances, the budget, or financial summaries to determine expectations for the entity's financial position and results of operations. When preliminary analytical procedures use data summarized at a high level, the results of these procedures provide only a broad initial indication about whether a material misstatement may exist. The auditor should consider the results of these procedures along with other information gathered when identifying risks of material misstatement.

b. **Compare current-year amounts to expectations.** Use of unaudited comparative data may not allow the auditor to identify significant fluctuations, particularly if an item consistently has been treated incorrectly, for example, if all accruals were not recorded. Also, the auditor may identify fluctuations that are not really fluctuations because of errors or omissions in unaudited comparative data.

   Key to effective preliminary analytical procedures is using information that is comparable in terms of the time period presented and the presentation (i.e.,

same level of detail and consistent grouping of detailed accounts into summarized amounts used for comparison).

The auditor may perform ratio analysis on current-year data and compare the current year's ratios with expectations based on those derived from prior periods or budgets. The auditor does this to study the relationships among components of the financial statements and to increase auditor knowledge of the entity's activities. The auditor uses ratios that are relevant indicators or measures for the entity. Also, the auditor should consider any trends in the entity-prepared performance indicators.

c. **Identify significant fluctuations.** The auditor identifies fluctuations, which are differences between the recorded amounts and the amounts expected by the auditor, based on comparative financial information and the auditor's knowledge of the entity. Fluctuations refer to both unexpected differences between current-year amounts and comparative financial information as well as the absence of expected differences.

The auditor generally should establish parameters for identifying significant fluctuations. When setting these parameters, the auditor may consider the amount of a fluctuation in terms of absolute size, the percentage difference, or both. The amount and percentage used are usually based on materiality. An example of a parameter is "All fluctuations in excess of $10 million and/or 15 percent of the expectation or other unusual fluctuations (such as debit amounts in accounts having normally credit balances) will be considered significant."

d. **Inquire about significant fluctuations.** Fluctuations may result from errors or fraud, from changes in operations, or from changes in the entity organization that the auditor did not consider when determining expectations. The auditor should discuss identified fluctuations with appropriate entity personnel. This discussion should focus on whether the fluctuation could result from error or fraud and whether the auditor adequately understands the entity's operations. In doing this, the auditor should consider the types of errors or fraud that could have caused the fluctuations.

For preliminary analytical procedures, the auditor does not need to corroborate the explanations as they will be tested later. However, the auditor should determine whether the explanations obtained appear reasonable and consistent. If the entity personnel indicate that the operations or organization has changed, the auditor may adjust the expectations and then determine whether there is still a significant fluctuation. The inability of appropriate entity personnel to explain the cause of a fluctuation may indicate a risk of material misstatement due to error or fraud.

.04 The auditor should consider the results of preliminary analytical procedures in assessing the risks of material misstatement due to error or fraud (see FAM 265).

230 – Determine Materiality

.01 Materiality is one of several factors the auditor uses to determine the nature, extent, and timing of procedures. Misstatements, including omissions, are considered to be material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements.[21] Judgments about materiality are made in light of surrounding circumstances and are affected by the size or nature of a misstatement, or a combination of both. Judgments about materiality involve both quantitative and qualitative considerations, such as the public accountability of the entity under audit, various legal and regulatory requirements, and the visibility and sensitivity of government programs. Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered. (AU-C 320.02).

.02 When establishing the overall audit strategy, the auditor should determine materiality for the financial statements as a whole. If, in the specific circumstances of the entity, one or more particular line items, accounts, note disclosures, or classes of transactions exist for which there is a substantial likelihood that misstatements of lesser amounts than materiality for the financial statements as a whole would influence the judgment made by a reasonable user based on the financial statements, the auditor also should determine the materiality level or levels to be applied to the particular line items, accounts, note disclosures, or classes of transactions. (AU-C 320.10)

.03 Materiality is based on the concept that items of little importance, which would not affect the judgment or conduct of a reasonable user, do not require auditor investigation. Materiality has both quantitative and qualitative aspects. Certain misstatements or omissions, even though quantitatively immaterial, could have a material impact on or warrant disclosure in the financial statements for qualitative reasons.

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

.05 U.S. GAAS, as incorporated in GAGAS, indicates that the auditor should use materiality in planning and performing the audit; evaluating the effect of identified misstatements on the audit, and the effect of uncorrected misstatements, if any, on the financial statements; and forming the opinion in the auditor's report (AU-C 320.05).

.06 The term materiality is used within several contexts in the FAM. The FAM uses the following terms that relate to materiality:

[21]Statement of Federal Financial Accounting Concepts (SFFAC) 1, *Objectives of Federal Financial Reporting*, issued by FASAB provides a slightly different definition of materiality. Since SFFACs are nonauthoritative, and in SFFAC 1, the board recognizes differences from the audit definition, the FAM is based on the definition provided in AU-C 200.07.

- **Materiality for the financial statements as a whole** is based on professional judgment and is a preliminary estimate in relation to the financial statements as a whole, primarily based on quantitative measures. It is used to determine performance materiality, which in turn is used to determine tolerable misstatement. These are then used to determine the risks of material misstatement and the nature, extent, and timing of substantive audit procedures. It is also used to identify significant provisions of applicable laws, regulations, contracts, and grant agreements for compliance testing.
- **Performance materiality** is the amount or amounts set by the auditor as a portion of materiality that the auditor allocates to line items, accounts, note disclosures, and classes of transactions (such as disbursements). The auditor should determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing, and extent of further audit procedures (AU-C 320.11). Performance materiality is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds materiality for the financial statements as a whole (AU-C 320.09).
- **Tolerable misstatement** is the application of performance materiality to a particular substantive sampling procedure. Tolerable misstatement is defined in AU-C 530.05 as a monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population. Based on the auditor's judgment, the auditor may set tolerable misstatement equal to or less than performance materiality, as discussed in FAM 230.13, and may set different amounts of tolerable misstatement for substantive sampling procedures of specific line items, accounts, note disclosures, classes of transactions, or assertions.
- **Clearly trivial** is the amount below which misstatements would not need to be accumulated because the auditor expects that the accumulation of such amounts clearly would not have a material effect on the financial statements. Misstatements that are clearly trivial are those that are clearly inconsequential, whether taken individually or in the aggregate and whether judged by any criteria of size, nature, or circumstances (AU-C 450.A2 and .A3). The clearly trivial amount set by the auditor should be substantially below performance materiality so that the aggregate of many items at the clearly trivial amount would not exceed tolerable misstatement. For example, a threshold that is 5 percent (or less) of performance materiality may be sufficiently low.

.07 The FAM also uses the term materiality in the reporting phase.

- **FMFIA materiality** is the threshold that management establishes for determining whether a matter meets OMB criteria for reporting matters under FMFIA, as described in FAM 580.60 and .61.
- **Management representation letter materiality.** See FAM 1001.07.
- **Legal counsel materiality.** See FAM 1002.19 through .22.

.08 The following guidelines provide the auditor with a framework for determining materiality. However, this framework is not a substitute for professional judgment. The auditor may determine materiality outside of these guidelines. In such

circumstances, the basis for the determination must be provided to the reviewer in a timely manner to allow any issues to be promptly identified and resolved. The auditor should document materiality and the method of determining materiality. The audit director should review and approve the documentation.

The auditor should determine materiality in relation to the element of the financial statements that the auditor judges is most significant to the primary users of the statements (the materiality benchmark). The auditor generally uses preliminary information to estimate the materiality benchmark. This may be prior years' audited financial statements or current-year unaudited and unadjusted interim information. The auditor should revise materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular line items, accounts, note disclosures, or classes of transactions) in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially (AU-C 320.12).

To provide reasonable assurance that sufficient audit procedures are performed, the auditor may estimate the materiality benchmark at the low end of the possible materiality benchmark. If the auditor concludes that a lower materiality than that initially determined for the financial statements as a whole (and, if applicable, materiality level or levels for particular line items, accounts, note disclosures, or classes of transactions) is appropriate, the auditor should determine whether it is necessary to revise performance materiality and whether the nature, timing, and extent of the further audit procedures remain appropriate (AU-C 320.13).

.09 For capital-intensive entities, total assets may be an appropriate materiality benchmark. For expenditure-intensive entities, total expenses may be an appropriate materiality benchmark. Based on these concepts, the auditor generally should use as the materiality benchmark the greater of total assets or expenses. The materiality benchmark generally should be net of adjustments for intragovernmental balances and offsetting balances (see discussion of these adjustments in the next paragraph). The auditor may use other materiality benchmarks, such as total liabilities; equity; revenues; appropriations; or, if significant, line items.

If the statements are significantly different in magnitude, it may be appropriate to use different benchmarks to avoid over- or underauditing. For example, if an entity has a statement of social insurance with significantly large amounts compared to the statement of net cost, and the auditor uses total expenses from the statement of net cost as a benchmark, this could result in overauditing the statement of social insurance. Therefore, the auditor may determine a separate benchmark for the statement of social insurance.

The key is to use a materiality benchmark or benchmarks that the auditor believes are most critical to the users of the financial statements. This requires that the auditor understand users and the entity and the environment in which it operates.

.10 In determining the materiality benchmark, the auditor should decide how to handle significant **intragovernmental** balances (such as funds with the Treasury, Treasury securities, and inter-entity balances) and offsetting balances (such as future funding sources that offset certain liabilities and collections that are offset by transfers to other government entities) because of their different risks. Further, combining all of the accounts may distort the auditor's judgment when designing the nature, extent, and timing of audit procedures. Because

these amounts were removed from the materiality benchmark, as discussed in the previous paragraph, the auditor generally should establish a separate materiality benchmark for significant intragovernmental or offsetting balances.

For example, an entity that collects and remits funds on behalf of other entities could have operating accounts that are small in comparison to the funds processed on behalf of other entities. In this example, the auditor would determine a separate materiality for auditing (1) the offsetting accounts, using the balance of the offsetting accounts as the materiality benchmark, and (2) the rest of the financial statements, using the materiality benchmark guidance in FAM 230.09.

.11 The auditor generally should set materiality at 3 percent of the materiality benchmark. Although the auditor may use a mechanical means to calculate materiality, the auditor should use judgment in evaluating whether the calculated level is appropriate. The auditor also should consider adjusting the materiality benchmark for the impact of items such as unrecorded liabilities, contingencies, and other items that are not incorporated in the entity's financial statements and therefore are not reflected in the materiality benchmark but may be important to the financial statement user.

.12 The auditor generally should set performance materiality at one-third of materiality to allow for the precision of audit procedures. This guideline recognizes that misstatements may occur throughout the entity's various accounts. The performance materiality represents the materiality used as a starting point to design audit procedures for assertions in line items, accounts, note disclosures, and classes of transactions. Doing so allows the auditor to detect an aggregate material misstatement in the financial statements. See FAM 545 for consideration of this precision allowance when evaluating the effects of misstatements on the financial statements for the purpose of reporting on the financial statements. The auditor may set a separate performance materiality level for a particular line item, account, note disclosure, or class of transactions.

.13 The auditor generally sets tolerable misstatement for a specific test the same as for the performance materiality. However, the auditor may set a tolerable misstatement lower than the performance materiality for substantive sampling procedures of specific line items, accounts, note disclosures, classes of transactions, or assertions (which increases the extent of testing), particularly when

- the population from which the audit sample is selected approximates or is lower than the balance or activity being tested or
- the area tested is sensitive to the financial statement users or may be qualitatively material.

.14 The materiality levels that the auditor sets should be used only by the auditor for planning and performing the audit and should not be used by management. Management should establish its own materiality for reporting purposes.

235 – Identify Material Line Items, Accounts, Note Disclosures, and Classes of Transactions; Applicable Assertions; and Significant Financial Management Systems

Identify Line Items, Accounts, Note Disclosures, and Classes of Transactions

.01 The auditor should identify

- line items in the financial statements,
- accounts in the entity's general ledger that make up each line item,
- note disclosures in the notes to the financial statements, and
- classes of transactions that the entity processes.

These line items, accounts, note disclosures, and classes of transactions include budget-related information, such as that presented in the statement of budgetary resources, reconciliation of net cost to net outlays,[22] and disclosure of the components of net position.

.02 A **class of transactions** is a category of events or activities that result in the recording of, or that support, financial data in the entity's general ledger accounts and, ultimately, the reporting of financial statement line items or disclosure of information in the notes to the financial statements. Classes of transactions are classified as transaction-related or line item/account-related.

- Transaction-related classes of transactions are the events and activities that occur during the period under audit and result in debit and credit entries to the entity's accounts (e.g., billing, purchasing, cash receipts, cash disbursements, journal vouchers, and adjusting entries). Transactions within each class are generally subject to similar risks and internal controls. These classes of transactions generally affect line items reported on all financial statements.
- Line item/account-related classes of transactions are the activities (e.g., maintenance of subsidiary records) that support balances that exist at period-end (e.g., cash balance, property balance, and accounts payable balance). These classes of transactions generally affect line items reported on the balance sheet or ending balances reported on the statement of budgetary resources.

.03 The auditor may group related line items, accounts, note disclosures, and classes of transactions to form **cycles**. For example, the auditor might group the billing class of transactions, cash receipts class of transactions, accounts receivable line item and related accounts, revenue line item and related accounts, and related note disclosures to form the revenue cycle. Grouping related items into cycles can aid the auditor in preparing audit documentation and

[22]Per OMB reporting guidance, the reconciliation of net cost to net outlays may be presented as a financial statement or note to the financial statements.

designing audit procedures that are effective, efficient, and relevant to financial reporting objectives. The auditor uses professional judgment in deciding what items to include in a cycle, considering the relationships between them and the efficiencies that can be achieved by grouping them for purposes of preparing audit documentation and performing audit procedures. As appropriate, the auditor may designate subcycles within larger cycles.

Identify Material Line Items, Accounts, and Classes of Transactions

.04 The auditor should determine which of the entity's line items, accounts, and classes of transactions identified in FAM 235.01 are material. Identifying material line items, accounts, and classes of transactions lays the foundation for identifying risks of material misstatement discussed in FAM 265 and preparing the line item risk analysis (LIRA) form at FAM 395 H. A **line item, account, or class of transactions** is material if it has one or more of the following characteristics:

- Its balance or activity equals or exceeds performance materiality.
- Its balance or activity could be understated by an amount that equals or exceeds performance materiality. For example, a small or zero balance for an accrued liability could be understated by a material amount.
- Its balance or activity is qualitatively material, considering such factors as public accountability of the entity, legal or regulatory requirements, and visibility or sensitivity of government programs.

The auditor may also identify a line item, account, or class of transactions as material if it does not meet the characteristics above, but its balance or activity, when combined with other immaterial items, equals or exceeds performance materiality in the aggregate.

Identify Material Note Disclosures

.05 Note disclosures related to material line items, accounts, and classes of transactions are material note disclosures. In addition, the auditor should determine whether other note disclosures that are not directly related to a line item or account are material. Examples of note disclosures that are not directly related to a line item or account include those for fiduciary activities, subsequent events, and reconciliation of net cost to net outlays.

.06 Note disclosures may be quantitative or qualitative. A **quantitative** note disclosure is material if it meets the criteria in FAM 235.04. Determining whether a **qualitative** note disclosure is material, in the context of the applicable financial reporting framework (generally U.S. GAAP) and the entity's circumstances, is a matter that involves the exercise of professional judgment. Examples of qualitative note disclosures include

- information about objectives, policies, and processes for managing budgetary resources;
- information about events or circumstances that led to an impairment loss;
- description of an accounting policy; and
- description of the sensitivity of an exchange rate.

Identify Applicable Assertions

.07 Most of the auditor's work in forming an opinion on financial statements consists of obtaining and evaluating sufficient appropriate evidence concerning assertions. The auditor uses assertions to consider the different types of potential misstatements that may occur when identifying, assessing, and responding to the risks of material misstatement. Assertions are representations, explicit or otherwise, with respect to the recognition, measurement, presentation, and disclosure of information in the financial statements, which are inherent in management, representing that the financial statements are prepared in accordance with the applicable financial reporting framework (generally U.S. GAAP) (AU-C 315.12).

.08 The FAM provides the following five assertions:

1. **Existence or occurrence:** Transactions and events have occurred during the given period, have been recorded in the proper accounts, and pertain to the entity. An entity's assets, liabilities, net position, and budgetary balances exist at a given date and have been recorded in the proper accounts. Projected revenues and expenditures in the sustainability financial statements are valid.
2. **Completeness:** All transactions and events that should have been recorded have been recorded in the proper period and accounts. All assets, liabilities, net position, and budgetary balances that should have been recorded have been recorded in the proper period and accounts, and are properly included in the financial statements. Projections in the sustainability financial statements include all estimated future revenues and expenditures at present value that should have been included.
3. **Rights and obligations:** The entity holds or controls the rights to assets, and liabilities are the obligations of the entity, at a given date. The entity holds or controls the rights to budgetary resources, and budgetary obligations pertain to the entity, at a given date.
4. **Accuracy, valuation, and allocation:** Amounts and other data relating to recorded transactions and events have been appropriately recorded.[23] Assets, liabilities, net position, budgetary balances, and projections in the sustainability financial statements have been included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments have been appropriately recorded.
5. **Presentation and disclosure:** Financial and other information in the financial statements is appropriately aggregated or disaggregated and clearly described. Note disclosures are appropriately measured and described and are relevant and understandable in the context of the requirements of U.S. GAAP. All note disclosures that should have been included in the financial

[23]Other data include information that is recorded along with the transaction amount and are necessary for the proper recording of the transaction, such as transaction description, transaction date, trading partner, cost center, fund code, and other accounting codes the entity uses.

statements have been included. Disclosed transactions and events have occurred and pertain to the entity.

AU-C 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, provides 12 assertions within two categories. See FAM 235 A for a comparison of the above five assertions to the 12 assertions in AU-C 315.

.09 For each material line item, account, note disclosure, and class of transactions, the auditor should identify the **applicable assertions**. Some assertions may not be applicable for a given line item, account, note disclosure, or class of transactions. For example, the rights and obligations assertion is not applicable to revenues and expenses.

Identify Significant Financial Management Systems

.10 For material line items, accounts, note disclosures, and classes of transactions, the auditor should identify the financial management systems that support them. Financial management systems are the financial systems and the financial portions of mixed systems necessary to support financial management, including automated and manual processes, procedures, controls, data, hardware, software, and support personnel dedicated to operating and maintaining system functions. Financial management systems are used extensively in the federal government. Many of these systems share programs, data files, and hardware with one another and are connected to the larger corporate network that they depend on for services such as authentication and monitoring. In addition to producing financial and accounting information, these systems typically generate other information and reports used in management decision-making.

.11 If a financial management system supports a material line item, account, note disclosure, or class of transactions, then it generally is significant for evaluating the effectiveness of the entity's internal control over financial reporting. There may be multiple financial management systems that support a particular line item, account, note disclosure, or class of transactions. The auditor should determine whether all significant financial management systems have been identified. If the auditor determines that a financial management system that a service organization maintains is significant for evaluating the effectiveness of the entity's internal control over financial reporting, the auditor should follow the guidance in FAM 640.

.12 For CFO Act agencies, which are subject to FFMIA, the auditor determines whether the financial management systems comply substantially with (1) federal financial management systems requirements, (2) federal accounting standards, and (3) the *U.S. Standard General Ledger* (USSGL) at the transaction level (see FAM 701 and 701 A). If the auditor determines that a financial management system is significant for evaluating the effectiveness of the entity's internal control over financial reporting, then it generally is significant for determining whether the system complies substantially with FFMIA.

In addition to the financial management systems involved in processing financial transactions and preparing financial statements, significant financial management systems covered by FFMIA may also include systems supporting financial planning, management reporting, and budgeting activities; systems

accumulating and reporting cost information; and the financial portions of mixed systems, such as benefit payment, logistics, personnel, and acquisition systems.

Document Material Line Items, Accounts, Note Disclosures, and Classes of Transactions; Applicable Assertions; and Significant Financial Management Systems

.13 The auditor should prepare a **cycle matrix** or equivalent that links material line items, accounts, note disclosures, and classes of transactions to the related significant financial management systems, LIRA forms, and cycles, as applicable.

.14 The auditor should also document material line items, accounts, note disclosures, and classes of transactions, along with the applicable assertions, on the **LIRA form** at FAM 395 H or equivalent.

235 A – Comparison of AU-C 315 Assertions to FAM 235 Assertions

.01 AU-C 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement,* identifies 12 assertions within two categories: (1) classes of transactions and events, and note disclosures, for the period under audit and (2) account balances, and note disclosures, at the period-end. The auditor may use these categories of assertions or may express them differently, provided all aspects of the assertions have been covered (AU-C 315.A218). Table 235 A.1 compares the 12 assertions in AU-C 315 to the five assertions described in FAM 235.

Table 235 A.1: Comparison of AU-C 315 Assertions to FAM 235 Assertions[24]

AU-C 315 assertions	FAM 235 assertions
I. Assertions about classes of transactions and events, and note disclosures, for the period under audit	
1. **Occurrence** – Transactions and events that have been recorded or disclosed have occurred, and such transactions and events pertain to the entity.	1. **Existence or occurrence** – **Transactions and events have occurred** during the given period, have been recorded in the proper accounts, **and pertain to the entity.** An entity's assets, liabilities, net position, and budgetary balances exist at a given date and have been recorded in the proper accounts. Projected revenues and expenditures in the sustainability financial statements are valid. 5. **Presentation and disclosure** – Financial and other information in the financial statements is appropriately aggregated or disaggregated and clearly described. Note disclosures are appropriately measured and described and are relevant and understandable in the context of the requirements of U.S. GAAP. All note disclosures that should have been included in the financial statements have been included. **Disclosed transactions and events have occurred and pertain to the entity.**
2. **Completeness** – All transactions and events that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.	2. **Completeness** – **All transactions and events that should have been recorded have been recorded** in the proper period and accounts. All assets, liabilities, net position, and budgetary balances that should have been recorded have been recorded in the proper period and accounts and properly included in the financial statements. Projections in sustainability financial statements include all estimated future revenues and expenditures at present value. 5. **Presentation and disclosure** – Financial and other information in the financial statements is appropriately aggregated or disaggregated and clearly described. Note disclosures are appropriately measured and described and are relevant and understandable in the context of the requirements of U.S. GAAP. **All note disclosures that should have been included in the financial statements have been included.** Disclosed transactions and events have occurred and pertain to the entity.

[24]For each AU-C 315 assertion listed in the left column, the table lists the related FAM 235 assertion(s) in the right column, with the corresponding aspects of the assertion(s) in **bold** font.

AU-C 315 assertions	FAM 235 assertions
I. Assertions about classes of transactions and events, and note disclosures, for the period under audit	
3. **Accuracy** – Amounts and other data relating to recorded transactions and events have been recorded appropriately, and related disclosures have been appropriately measured and described.	4. **Accuracy, valuation, and allocation** – **Amounts and other data relating to recorded transactions and events have been recorded appropriately.** Assets, liabilities, net position, budgetary balances, and projections in sustainability financial statements have been included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments have been appropriately recorded. 5. **Presentation and disclosure** – Financial and other information in the financial statements is appropriately aggregated or disaggregated and clearly described. **Note disclosures are appropriately measured and described** and are relevant and understandable in the context of the requirements of U.S. GAAP. All note disclosures that should have been included in the financial statements have been included. Disclosed transactions and events have occurred and pertain to the entity.
4. **Cutoff** – Transactions and events have been recorded in the correct accounting period.	1. **Existence or occurrence** – **Transactions and events have occurred during the given period**, have been recorded in the proper accounts, and pertain to the entity. An entity's assets, liabilities, net position, and budgetary balances exist at a given date and have been recorded in the proper accounts. Projected revenues and expenditures in sustainability financial statements include all estimated future revenues and expenditures at present value. 2. **Completeness – All transactions and events that should have been recorded have been recorded in the proper period** and accounts. All assets, liabilities, net position, and budgetary balances that should have been recorded have been recorded in the proper period and accounts and are properly included in the financial statements. Projections in sustainability financial statements include all estimated future revenues and expenditures at present value.

	AU-C 315 assertions	FAM 235 assertions
I.	**Assertions about classes of transactions and events, and note disclosures, for the period under audit**	
	5. **Classification** – Transactions and events have been recorded in the proper accounts.	1. **Existence or occurrence** – **Transactions and events** have occurred during the given period**, have been recorded in the proper accounts**, and pertain to the entity. An entity's assets, liabilities, net position, and budgetary balances exist at a given date and have been recorded in the proper accounts. Projected revenues and expenditures in sustainability financial statements include all estimated future revenues and expenditures at present value. 2. **Completeness** – **All transactions and events that should have been recorded have been recorded in the proper** period and **accounts**. All assets, liabilities, net position, and budgetary balances that should have been recorded have been recorded in the proper period and accounts and are properly included in the financial statements. Projections in sustainability financial statements include all estimated future revenues and expenditures at present value.
	6. **Presentation** – Transactions and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework (generally U.S. GAAP).	5. **Presentation and disclosure** – **Financial and other information in the financial statements is appropriately aggregated or disaggregated, and clearly described. Note disclosures** are appropriately measured and described and **are relevant and understandable in the context of the requirements of U.S. GAAP**. All note disclosures that should have been included in the financial statements have been included. Disclosed transactions and events have occurred and pertain to the entity.

AU-C 315 assertions	FAM 235 assertions
II. Assertions about account balances, and note disclosures, at the period-end	
7. **Existence** – Assets, liabilities, and equity interests exist.	1. **Existence or occurrence** – Transactions and events have occurred during the given period, have been recorded in the proper accounts, and pertain to the entity. **An entity's assets, liabilities, net position,** and budgetary balances **exist at a given date** and have been recorded in the proper accounts. Projected revenues and expenditures in sustainability financial statements include all estimated future revenues and expenditures at present value.
8. **Rights and obligations** – The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.	3. **Rights and obligations – The entity holds or controls the rights to assets, and liabilities are the obligations of the entity,** at a given date. The entity holds or controls the rights to budgetary resources, and budgetary obligations pertain to the entity, at a given date.
9. **Completeness** – All assets, liabilities, and equity interests that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.	2. **Completeness** – All transactions and events that should have been recorded have been recorded in the proper period and accounts. **All assets, liabilities, net position,** and budgetary balances **that should have been recorded have been recorded** in the proper period and accounts and are properly included in the financial statements. Projections in sustainability financial statements include all estimated future revenues and expenditures at present value. 5. **Presentation and disclosure** – Financial and other information in the financial statements is appropriately aggregated or disaggregated and clearly described. Note disclosures are appropriately measured and described and are relevant and understandable in the context of the requirements of U.S. GAAP. **All note disclosures that should have been included in the financial statements have been included.** Disclosed transactions and events have occurred and pertain to the entity.

AU-C 315 assertions	FAM 235 assertions
II. Assertions about account balances, and note disclosures, at the period-end	
10. **Accuracy**, **valuation, and allocation** – Assets, liabilities, and equity interests have been included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.	4. **Accuracy, valuation, and allocation** – Amounts and other data relating to recorded transactions and events have been recorded appropriately. **Assets, liabilities, net position,** budgetary balances, and projections in sustainability financial statements **have been included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments have been appropriately recorded.** 5. **Presentation and disclosure** – Financial and other information in the financial statements is appropriately aggregated or disaggregated and clearly described. **Note disclosures are appropriately measured and described** and are relevant and understandable in the context of the requirements of U.S. GAAP. All note disclosures that should have been included in the financial statements have been included. Disclosed transactions and events have occurred and pertain to the entity.
11. **Classification** – Assets, liabilities, and equity interests have been recorded in the proper accounts.	1. **Existence or occurrence** – Transactions and events have occurred during the given period, have been recorded in the proper accounts, and pertain to the entity. **An entity's assets, liabilities, net position**, and budgetary balances exist at a given date and **have been recorded in the proper accounts**. Projected revenues and expenditures in sustainability financial statements include all estimated future revenues and expenditures at present value. 2. **Completeness –** All transactions and events that should have been recorded have been recorded in the proper period and accounts. **All assets, liabilities, net position,** and budgetary balances that should have been recorded **have been recorded in the proper** period and **accounts** and are properly included in the financial statements. Projections in sustainability financial statements include all estimated future revenues and expenditures at present value.
12. **Presentation** – Assets, liabilities, and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework (generally U.S. GAAP).	5. **Presentation and disclosure** – **Financial and other information in the financial statements is appropriately aggregated or disaggregated and clearly described. Note disclosures are** appropriately measured and described and are **relevant and understandable in the context of the requirements of U.S. GAAP**. All note disclosures that should have been included in the financial statements have been included. Disclosed transactions and events have occurred and pertain to the entity.

245 – Identify Significant Provisions of Applicable Laws, Regulations, Contracts, and Grant Agreements

.01 AU-C 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, provides audit requirements related to laws and regulations, both those that have a direct effect and those that have an indirect effect on the financial statements. GAGAS (2018) 6.15 extends these requirements to the auditor's consideration of compliance with provisions of contracts and grant agreements.

.02 A direct effect means that the provision specifies

- the nature and/or dollar amount of transactions that may be incurred (such as obligation, outlay, or borrowing restrictions);
- the method used to record such transactions (such as revenue recognition policies); or
- the nature and extent of information to be reported or disclosed in the financial statements (such as the statement of budgetary resources).

For example, an entity enabling statute may contain provisions that limit the nature and amount of obligations or outlays and therefore have a direct effect on determining amounts and disclosures in the financial statements. If a provision's effect on the financial statements is limited to contingent liabilities as a result of noncompliance (typically for fines, penalties, and interest), such a provision does not have a direct effect on determining financial statement amounts and note disclosures. The concept of direct effect is also discussed in AU-C 250.

.03 The auditor should obtain sufficient appropriate audit evidence regarding material amounts and disclosures in the financial statements that are determined by those provisions of laws, regulations, contracts, and grant agreements generally recognized to have a direct effect on their determination (AU-C 250.13).

.04 The auditor generally should use the General Compliance Checklist in FAM 802 or equivalent to determine which laws and regulations are significant for testing compliance.

.05 In contrast, an indirect effect relates generally to the entity's operating aspects and not to directly affecting the determination of amounts or disclosures in the financial statements. In other words, the effect may be limited to recording or disclosing liabilities **arising from noncompliance**. Examples of provisions of indirect laws and regulations include those related to environmental cleanup and occupational safety and health.

.06 The auditor should identify the significant provisions of applicable laws, regulations, contracts, and grant agreements. These provisions are those (1) for which compliance can be objectively determined and (2) that have a direct effect on the determination of material amounts and disclosures in the financial statements as defined in FAM 245.07b. To aid the auditor in this process, the FAM classifies provisions of laws and regulations into the following categories:

- **Transaction-based provisions** are those for which compliance is determined for individual transactions. For example, provisions of the Prompt

Payment Act require that late payments be individually identified and interest paid on such late payments.

- **Quantitative-based provisions** are those that require the accumulation or summarization of amounts for measurement. These provisions may contain minimum, maximum, or targeted amounts (restrictions) for the accumulated/summarized information. For example, provisions of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 prohibit the U.S. Environmental Protection Agency from exceeding certain spending limits on specific projects.
- **Procedural-based provisions** are those that require the entity to implement policies or procedures to achieve certain objectives. For example, provisions of the Single Audit Act require the awarding entity to review certain financial information about recipients.

During the planning phase, the auditor should attempt to identify the significant provisions of contracts and grant agreements, recognizing that during this phase the auditor may not be in position to identify all the significant provisions of contracts and grant agreements. However, as the audit progresses, the auditor may become aware of significant provisions of contracts and grant agreements and, as a result, perform transaction testing of these contracts and grant agreements provisions. For example, the auditor may test the budgetary and proprietary transactions associated with lease agreement provisions.

.07 For each significant provision, the auditor should identify and evaluate related compliance controls and should test compliance with the provision. To identify such significant provisions, the auditor should do the following:

a. Review the list of laws included in FAM 295 H. The auditor should also review the list of laws, regulations, contracts, and grant agreements that the entity has determined might be significant. In addition, the auditor should identify any laws, regulations, contracts, or grant agreements (in addition to those identified in FAM 295 H and by the entity) that have a direct effect on determining amounts and disclosures in the financial statements. These might include (1) new laws and regulations and (2) entity-specific laws and regulations. The auditor's Office of the General Counsel (OGC) assists the auditor in identifying laws and regulations. The meaning of direct effect is discussed in FAM 245.02.

b. Identify those provisions that are significant. A provision is significant if (1) compliance with the provision can be measured objectively and (2) it meets one of the following criteria for determining that the provision has a direct effect on determining material amounts and disclosures in the financial statements:

   - **Transaction-based provisions:** The aggregate amount of transactions the entity processes that are subject to the provision equals or exceeds materiality.
   - **Quantitative-based provisions:** The amount required to be accumulated or summarized for measurement by the provision equals or exceeds materiality.

- **Procedural-based provisions:** The provision broadly affects all or a segment of the entity's operations that process transactions equal to or exceeding materiality in the aggregate. For example, a provision may require that the entity establish procedures to monitor the receipt of certain information from grantees. In determining whether to test compliance with this provision, the auditor should determine whether the total amount of money granted equals or exceeds materiality.

c. Significant provisions of contracts and grant agreements may not be able to be identified during planning. If so, the auditor should determine during planning the approach for identifying and testing such provisions during later phases of the audit. The provisions may be identified as part of substantive testing of transactions and balances, when the auditor finds that material amounts and note disclosures related to such transactions and balances are determined by contracts or grant agreements. For example, a contract or grant agreement generally contains certain information, such as the amount or basis for determining the amounts to be paid and the timing of such payments, that directly affects the amounts reported or disclosed in the financial statements. To test such transactions and balances, the auditor may determine that it is necessary to examine contracts or grant agreements to obtain sufficient appropriate evidence supporting the transaction or balance. In other instances, such as those related to the provision of routine goods and services, the auditor may determine that it is not necessary to examine contracts or grant agreements to obtain sufficient appropriate evidence supporting the transaction or balance.

.08 Based on AU-C 250.A10, the auditor's responsibilities regarding misstatements resulting from noncompliance with laws, regulations, contracts, and grant agreements having a direct effect on the determination of material amounts and disclosures in the financial statements is the same as that for misstatements caused by fraud or error. Such risks of material misstatement resulting from noncompliance may be at the assertion or financial statement level.

.09 For **indirect** laws, regulations, contracts, or grant agreements, the auditor should perform the following procedures that may identify instances of noncompliance that may have a material effect on the financial statements:

a. Inquire of management and, when appropriate, those charged with governance regarding policies and procedures that prevent noncompliance and whether the entity is in compliance with those provisions (AU-C 250.14a).

b. Consider instances of noncompliance that may be identified in performing other audit procedures and determine if they could have a material effect on the financial statements.

c. Review reports issued by other oversight bodies of the audited entity, such as the IG's office, for any reported instances of noncompliance and determine if they could be material to the financial statements.

d. Inspect correspondence, if any, with relevant regulatory authorities (AU-C 250.14b).

Unless possible instances of noncompliance with indirect laws, regulations, contracts, or grant agreements come to the auditor's attention during the audit, no further procedures with respect to indirect laws, regulations, contracts, and

grant agreements are necessary. The auditor is not responsible for testing compliance controls over or compliance with any indirect laws, regulations, contracts, or grant agreements (AU-C 250.16).

.10 The auditor may test compliance with **indirect** laws, regulations, contracts, and grant agreements. For example, if the auditor becomes aware that the entity has operations similar to those of another entity that was recently in noncompliance with environmental laws and regulations, the auditor may test for compliance with such laws and regulations. The auditor may also test provisions of direct laws, regulations, contracts, and grant agreements that do not meet the materiality criteria in FAM 245.07b but that are deemed significant because they are qualitatively material, such as laws and regulations that have generated significant interest by the Congress, the media, or the public.

.11 In considering regulations to test for compliance, the auditor should consider externally imposed requirements issued pursuant to the Administrative Procedure Act. These would include regulations in the *U.S. Code of Federal Regulations* as well as OMB circulars and bulletins to the extent issued under direction of law. It would not include OMB circulars and bulletins to the extent issued as a matter of policy or guidance under the entity's general authority. Internal policies, manuals, and directives may be the basis for internal controls but are not regulations to consider for testing compliance. The auditor should consult its OGC if the direction of law determination is not clear.

.12 The auditor should remain alert to the possibility that procedures applied during other aspects of the audit might indicate actual or suspected noncompliance with provisions of laws, regulations, contracts, or grant agreements (AU-C 250.15). See FAM 460.06 for the procedures to perform for instances of noncompliance or suspected noncompliance (whether direct or indirect).

250 – Identify Relevant Budget Restrictions

.01 The auditor should identify relevant budget restrictions, evaluate budget controls (see FAM 295 G), and design compliance-related audit procedures relevant to budget restrictions. Some key documents that may be obtained from the entity or the auditor's OGC are

- the Antideficiency Act (ADA), as provided primarily in 31 U.S.C. chapters 13, 15. Provisions: 31 U.S.C. §§ 1341(a)(1)(A), (B); and 31 U.S.C. § 1517(a);
- the Purpose Statute, as provided in 31 U.S.C. § 1301;
- the Time Statute, as provided in 31 U.S.C § 1502;
- OMB Circular No. A-11, *Preparation, Submission and Execution of the Budget*, Part 4;
- the Impoundment Control Act, as provided in 2 U.S.C. chapter 17B; and
- the Federal Credit Reform Act (FCRA), as provided in 2 U.S.C. §§ 661-661f (if the entity has activity subject to this law). Provisions: 2 U.S.C. § 661c(b), (e).

Title 7 of GAO's *Policy and Procedures Manual for Guidance of Federal Agencies* and GAO's *Principles of Federal Appropriations Law* (commonly known as the Red Book) provide guidance on compliance with budget restrictions. The USSGL within the *Treasury Financial Manual* provides guidance on budgetary accounting.

.02 Information relating to the entity's appropriation (or other budget authority) for the period of audit includes

- authorizing statute;
- enabling statute;
- appropriation act and supplemental appropriation act;
- apportionments and budget execution reports (including OMB forms 132 and 133 and supporting documentation);
- Impoundment Control Act reports regarding rescissions and deferrals, if any;
- the OMB-approved system of funds control document; and
- any other information that the auditor deems to be relevant to understanding the entity's budget authority, such as legislative history contained in committee reports or conference reports.

Although legislative histories are not legally binding, they may help the auditor understand the political environment surrounding the entity (e.g., why the entity has undertaken certain activities and the objectives of these activities). SFFAS 43, *Funds from Dedicated Collections: Amending SFFAS 27, Identifying and Reporting Earmarked Funds*, may also help the auditor identify revenues or other financing sources of the federal entity.

.03 Through discussions with the auditor's OGC and the entity, and by using the above information and information prepared by management, the auditor should identify all **legally binding** restrictions on the entity's use of appropriated funds

that are relevant to budget execution. This includes any restrictions on the amount, purpose, or timing of obligations and outlays (i.e., relevant budget restrictions). Additionally, the auditor should determine whether the entity has established any legally binding restrictions in its fund control regulations. An example of this would be the entity's lowering the legally binding level for compliance with the Antideficiency Act to the allotment level.

.04 The auditor should obtain advice from the auditor's OGC on the implications if the entity were to violate these relevant budget restrictions. In the internal control phase, the auditor identifies the design of and tests the entity's controls to prevent or detect noncompliance with these relevant restrictions. The auditor may evaluate controls over budget restrictions that are not legally binding but that may be considered sensitive or important.

.05 During these discussions with the auditor's OGC and the entity, the auditor should determine whether any of these relevant budget restrictions relate to significant provisions of applicable laws and regulations for purposes of testing compliance.

.06 For an entity that does not receive appropriated funds, the auditor should identify budget-related requirements that are legally binding on the entity. These requirements, if any, are usually found in the statute that created the entity or its programs (such as the authorizing and enabling statute) as well as any subsequent amendments. Although budget information on these entities may be included in the President's budget submitted to the Congress, this information usually is not legally binding. In general, certain budget-related restrictions (such as provisions of the Antideficiency Act) apply to government corporations but not to government-sponsored enterprises.

260 – Understand the Entity's Internal Control

Overview of Internal Control

.01 Internal control over financial reporting, as defined in OMB audit guidance, is a subset of the entity's internal control and includes the following (GAGAS and OMB audit guidance expand compliance to include contracts and grant agreements).[25]

- Reliability of **financial reporting**: Transactions are properly recorded, processed, and summarized to permit the preparation of the financial statements in accordance with U.S. GAAP, and assets are safeguarded against loss from unauthorized acquisition, use, or disposition. (Note that certain **safeguarding** controls are part of financial reporting controls, although they are also operations controls. See FAM 310.07–.09.)
- **Compliance** with laws, regulations, contracts, and grant agreements: Transactions are executed in accordance with provisions of applicable laws, including those governing the use of budget authority; regulations; contracts; and grant agreements, noncompliance with which could have a material effect on the financial statements. (Note that **budget** controls are part of financial reporting controls as they relate to the statement of budgetary resources and the reconciliation of net cost to net outlays. They are also part of compliance controls in that they are used to manage and control the use of appropriated funds and other forms of budget authority in accordance with applicable law. These controls are described in more detail in FAM 295 G.)

.02 Most controls relevant to the audit are likely to relate to financial reporting; however, not all controls that relate to financial reporting are relevant to the audit. In addition, some controls belong in more than one category of control. For example, financial reporting controls include controls over the completeness and accuracy of inventory records. Such controls are also necessary to provide complete and accurate inventory records to allow management to analyze and monitor inventory levels to better control operations and make procurement decisions (**operations** controls).

.03 The five components of internal control and related principles defined in GAO's *Standards for Internal Control in the Federal Government* (Green Book) relate to objectives that an entity strives to achieve in each of the three categories described above: financial reporting (including safeguarding), compliance, and operations controls. The components are as follows.[26]

[25]Internal control as defined in the Green Book is a process effected by an entity's oversight body, management, and other personnel that provides reasonable assurance that the objectives of the entity will be achieved.

[26]AU-C 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, identifies the five components of internal control as control environment, the entity's risk assessment process, the entity's process to monitor the system of internal control, the information system and communication, and control activities. The components in AU-C 315 are described in the context of a financial statement audit, whereas GAO's Green Book defines the components in the context of internal control overall. The FAM's descriptions of internal control components are generally aligned with the Green Book, which is specific to federal entities.

- **Control environment.** The foundation for an internal control system. It provides the discipline and structure to help an entity achieve its objectives.
- **Entity risk assessment.** Assesses the risks facing the entity as it seeks to achieve its objectives. This assessment provides the basis for developing appropriate risk responses.
- **Information and communication.** The quality information management and personnel communicate and use to support the internal control system.
- **Monitoring.** Activities management establishes and operates to assess the quality of performance over time and promptly resolve the findings of audits and other reviews.
- **Control activities.** The actions management establishes through policies and procedures to achieve objectives and respond to risks in the internal control system, which includes the entity's information system.

.04 During the planning phase, the auditor should understand and evaluate the design and implementation of the five components of internal control. Specific conditions that may indicate deficiencies in the control environment, entity risk assessment, information and communication, or monitoring components are provided in FAM 295 B. The understanding of specific control activities is discussed in FAM 340.[27]

.05 Based on AU-C 315.A111, the auditor's understanding and evaluation of the five components of internal control provides a preliminary understanding of how the entity identifies risks relevant to financial reporting and how it responds to them. It may also influence the auditor's identification and assessment of the risks of material misstatement in different ways (see FAM 265). For example:

- The auditor's understanding of the control environment, entity risk assessment, and monitoring components is more likely to affect the identification and assessment of risks of material misstatement at the financial statement level.
- The auditor's understanding of the information and communication component is more likely to affect the identification and assessment of risks of material misstatement at the assertion level, but it may also affect the identification and assessment of risks of material misstatement at the financial statement level.[28]
- The auditor's understanding of the control activities component is more likely to affect the identification and assessment of risks of material misstatement at the assertion level.

.06 Based on the auditor's understanding and evaluation of the design and implementation of the five components of internal control, the auditor should determine whether one or more control deficiencies have been identified (AU-C

[27]"Control activities" as used in the FAM are referred to as controls in the control activities component in AU-C 540, *Auditing Accounting Estimates and Related Disclosures*.

[28]In obtaining an understanding of how information relating to material line items, accounts, note disclosures, and classes of transactions flows into, through, and out of the entity's information processes, the auditor may also identify controls that are evaluated as part of the control activities component, especially related to information technology. The Green Book primarily discusses controls related to information technology in the control activities component.

315.31). If the auditor identified a deficiency, the auditor should determine whether (1) the deficiency is a material weakness, significant deficiency, or other control deficiency and (2) to report the deficiency in the auditor's report or a separate report to management (see FAM 580).

.07 The following discusses each internal control component in more detail, the effect of information technology on internal control, and other aspects of the entity's internal control processes that the auditor should understand.

Control Environment

.08 The auditor should evaluate the design of the control environment component and determine whether it has been implemented. The control environment is the foundation for an internal control system. It provides the discipline and structure, which affect the overall quality of internal control. It influences how objectives are defined and how control activities are structured. Those charged with governance and management establish and maintain an environment throughout the entity that sets a positive attitude toward internal control. The underlying principles for this component are as follows (Green Book):

- Those charged with governance and management should demonstrate a commitment to integrity and ethical values.
- Those charged with governance should oversee the entity's internal control system.
- Management should establish an organizational structure, assign responsibility, and delegate authority to achieve the entity's objectives.
- Management should demonstrate a commitment to recruit, develop, and retain competent individuals.
- Management should evaluate performance and hold individuals accountable for their internal control responsibilities.

.09 The control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity's internal control and its importance in the entity (AU-C 315.A276). Based on AU-C 315.A276 and the Green Book, elements of the control environment that may be relevant when obtaining an understanding of the control environment include the following:

- integrity, ethical values, and standards of conduct;
- commitment to competence;
- participation by those charged with governance;
- management's philosophy and operating style;
- organizational structure;
- assignment of authority and responsibility;
- human resource policies and practices;
- management's control methods over budget formulation and execution;
- management's control methods over compliance with applicable laws, regulations, contracts, and grant agreements;

- documentation of the internal control system;
- succession and contingency plans and preparation; and
- enforcing accountability and considering excessive pressure.

.10 Based on AU-C 315.21 and .42b, the auditor should, through performing risk assessment procedures, obtain and document an understanding of the control environment component and the underlying principles, relevant to the preparation of the financial statements, by

a. understanding the set of controls, processes, and structures that address
   - how management's oversight responsibilities are carried out, such as the entity's culture and management's commitment to integrity and ethical values;
   - when those charged with governance are separate from management, the independence of, and oversight over the entity's internal control by, those charged with governance;
   - the entity's assignment of authority and responsibility;
   - how the entity attracts, develops, and retains competent individuals; and
   - how the entity holds individuals accountable for their responsibilities in the pursuit of the objectives of internal control.

b. evaluating, based on the auditor's understanding, whether
   - management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior;
   - the control environment provides an appropriate foundation for the other components of internal control, considering the nature and complexity of the entity; and
   - control deficiencies identified in the control environment undermine the other components of internal control.

In making this evaluation, the auditor should obtain an understanding of the nature and extent of oversight and governance that the entity has in place over management's financial reporting process relevant to accounting estimates (AU-C 540.12e and .A29).

.11 In evaluating the design of the control environment and determining whether it has been implemented, the auditor determines whether the control environment enhances or mitigates the effectiveness of specific control activities (Green Book 10.03). In making this determination, the auditor should evaluate the following factors and their effect on internal control. For each factor listed below, FAM 295 B lists conditions that may indicate control environment deficiencies.

a. **Integrity, ethical values, and standards of conduct.** Control effectiveness cannot rise above the integrity and ethical values of those who create, administer, and monitor the controls. Management's integrity and ethical values are essential elements of the control environment, affecting the design, administration, and monitoring of the other components. Integrity and ethical behavior result when the entity's leaders have high ethical and behavioral standards and properly communicate them and reinforce them in

practice. The standards include management's actions to remove or reduce incentives and temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts. Management also establishes a process for evaluating employees' adherence to the organization's standards of conduct and remediates any deviations timely and consistently (Green Book 1.10).

The communication of entity values and behavioral standards to personnel may take place through policy statements and codes of conduct and by example. Those charged with governance and management set the tone at the top and throughout the organization by their example, which is fundamental to an effective internal control system. Without a strong tone at the top to support an internal control system, the entity's risk identification may be incomplete, risk responses may be inappropriate, control activities may not be designed or implemented effectively, information and communication may falter, and results of monitoring may not be understood or acted upon to remediate deficiencies (Green Book 1.02–1.05).

b. **Commitment to competence.** Competence is the knowledge and skills necessary to accomplish tasks required by an individual's job. Commitment to competence includes management's consideration of the competence levels for various jobs and the requisite skills, knowledge, and abilities, which are gained largely from professional experience, training, and certifications. Management establishes expectations of competence for key roles, and other roles at management's discretion, to help the entity achieve its objectives. Management considers standards of conduct, assigned responsibility, and delegated authority when establishing expectations (Green Book 4.02–4.04). It is supplemented by effective human resources policies and practices, as discussed below.

c. **Participation by those charged with governance.** Those charged with governance are responsible for overseeing the financial reporting process, including internal control over financial reporting. This includes providing management with input for remediation and oversight of deficiencies in the internal control system as appropriate (Green Book 2.11–2.13). For a federal entity, those charged with governance may be members of a board or commission, an audit committee, the secretary of a cabinet-level department, OMB, the Department of the Treasury, or senior executives and financial managers responsible for the entity (Green Book 2.05). They oversee the entity's operations, provide constructive criticism to management, and where appropriate make oversight decisions so that the entity achieves its objectives in alignment with the entity's integrity and ethical values (Green Book 2.02 and 2.07). Capabilities expected of all members of those charged with governance include integrity and ethical values, leadership, critical thinking, and problem-solving abilities (Green Book 2.06). The effectiveness of those charged with governance is influenced by their authority and role in monitoring an entity's financial reporting process.

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

attitude toward information processing, accounting, personnel, and internal control.

e. **Organizational structure.** An entity's organizational structure provides the overall framework for planning, executing, directing, controlling, and assessing the organization's operations in achieving its objectives. The organizational structure assigns authority and responsibility within the entity. An organizational structure includes the form and nature of an entity's organizational units, including the data processing organization, and related management functions and reporting relationships, which are defined at all levels of the organization and provide methods of communication that can flow down, across, up, and around the structure. Management periodically evaluates the organizational structure so that it meets the entity's objectives and has adapted to any new objectives for the entity, such as a new law or regulation (Green Book 3.02–3.05).

f. **Assignment of authority and responsibility.** An entity's policies or procedures for assigning authority for operating activities and for delegating responsibility affect the understanding of established reporting relationships and responsibilities. These responsibilities are assigned to discrete units to enable the organization to operate in an efficient manner, comply with applicable laws and regulations, and reliably report quality information. Management determines the level of authority and delegates that authority only to the extent required to achieve the entity's objectives. As part of delegating authority, management establishes the key roles and evaluates the delegation for proper segregation of duties within the unit and in the organizational structure (Green Book 3.06–3.08, 10.02, 10.03, 12.03, and 12.04). This factor includes policies relating to appropriate business practices, knowledge and experience of key personnel, and resource allocations. It also includes policies and communications to enable personnel to understand the entity's objectives, how they contribute to these objectives, and how and for what they will be held accountable. Management should periodically review policies, procedures, and related control activities for continued relevance and effectiveness in achieving the entity's objectives or addressing related risks (Green Book 12.05).

g. **Human resource policies and practices.** Human resource policies and practices affect an entity's ability to employ sufficient competent and trustworthy personnel to accomplish its goals and objectives. Such policies and practices include hiring, training, evaluating, promoting, compensating, mentoring, retaining, and assisting employees in performing their assigned responsibilities by giving them the necessary resources (Green Book 4.05).

h. **Management's control methods over budget formulation and execution.** Management's budget control methods affect the authorized use of appropriated funds. Budget formulation is discussed in more detail in FAM 260.55, and controls over budget execution (budget controls) are addressed in more detail in FAM 300.

i. **Management's control methods over compliance with laws, regulations, contracts, and grant agreements.** Such methods have a direct effect on an entity's compliance with applicable laws, regulations, contracts, and grant agreements. Compliance controls are addressed in more detail in FAM 300.

j. **Documentation of the internal control system.** Management develops and maintains documentation of its internal control system to meet organizational needs by establishing and communicating the who, what, when, where, and why of internal control execution to personnel through its policies. The extent of documentation needed to support the design, implementation, and operating effectiveness of the five components of internal control is a matter of management judgment (Green Book 3.09–3.12 and 12.02).

k. **Succession and contingency plans and preparation.** Management defines succession and contingency plans for key roles to help the entity continue achieving its objectives. Succession plans address the entity's need to replace competent personnel over the long term, whereas contingency plans address the entity's need to respond to sudden personnel changes that could compromise the internal control system. The importance of a key role in the internal control system and the impact to the entity of its vacancy dictate the formality and depth of the contingency plan (Green Book 4.06–4.08).

l. **Enforcing accountability and considering excessive pressure.** Management enforces accountability for individuals in performing their internal control responsibilities. Management holds personnel accountable through mechanisms such as performance appraisals and disciplinary actions. Management also holds service organizations accountable for their assigned internal control responsibilities. Management communicates to the service organization the objectives of the entity and their related risks, the entity's standards of conduct, the role of the service organization in the organizational structure, the assigned responsibilities and authorities of the role, and the expectations of competence for its role that will enable the service organization to perform its internal control responsibilities. Management, with oversight from those charged with governance, takes corrective action as necessary to enforce accountability for internal control in the entity (Green Book 5.02–5.06). Management is responsible for evaluating pressure on personnel to help personnel fulfill their assigned responsibilities in accordance with the entity's standards of conduct. Management adjusts excessive pressures on personnel in the entity. Pressure can appear in an entity because of goals management established to meet objectives or cyclical demands of various processes the entity performs (Green Book 5.07–5.08).

Entity Risk Assessment

.12 The auditor should evaluate the design of the entity risk assessment component and determine whether it has been implemented. Management assesses the risks the entity faces from both external and internal sources. This assessment provides the basis for developing appropriate risk responses. The underlying principles for this component are as follows (Green Book):

- Management should define objectives clearly to enable the identification of risks and define risk tolerances.
- Management should identify, analyze, and respond to risks related to achieving the defined objectives.
- Management should consider the potential for fraud when identifying, analyzing, and responding to risks.

- Management should identify, analyze, and respond to significant changes that could impact the internal control system.

.13 Based on AU-C 315.A276, the entity's risk assessment process is an iterative process for identifying and analyzing risks to achieving the entity's objectives. It also forms the basis for how management or those charged with governance determine the risks to be managed. The entity's risk assessment process includes how management

- identifies risks relevant to the preparation of the financial statements (including safeguarding of assets) and compliance with laws (including those governing the use of budget authority), regulations, contracts, and grant agreements;
- estimates their significance;
- assesses the likelihood of their occurrence; and
- decides on actions to manage them and the results thereof.

For example, the entity's risk assessment process may address how the entity considers the possibility of unrecorded transactions or identifies and analyzes significant estimates recorded in the financial statements or considers the risks of fraud.

.14 Risks relevant to reliable financial reporting include external and internal events, transactions, or circumstances that may occur and adversely affect an entity's ability to initiate, record, process, and report financial information consistent with the assertions of management in the financial statements. Based on AU-C 315.A276 and the Green Book, risks can arise or change due to circumstances, such as

- changes in the economic, operating, regulatory, or statutory environment;
- new personnel who may have a different focus on or understanding of the entity's internal control;
- the ability of management to override established controls;
- new or revamped information systems;
- rapid growth of programs, which can strain controls;
- new technology, which may change risks;
- new programs or activities, which may introduce new control risks;
- restructurings or budget cutbacks, which may include downsizing and changes in supervision and segregation of duties;
- adoption of new accounting principles or changing accounting principles, which may affect risks in preparing financial statements;
- use of information technology; or
- environmental, social, and governance issues.

.15 Based on AU-C 315.22, 315.42b, and 540.12g, the auditor should, through performing risk assessment procedures, obtain and document an understanding of the entity risk assessment component, and the underlying principles relevant to the preparation of the financial statements, by

- understanding the entity's process for
  - identifying risks, including those relating to accounting estimates and the potential for fraud, relevant to financial reporting objectives (including safeguarding and its service organizations) and its compliance with budget and other laws, regulations, contracts, and grant agreements;
  - assessing the significance of those risks, including the likelihood of their occurrence; and
  - addressing those risks.
- evaluating whether the entity's risk assessment process is appropriate to the entity's circumstances, considering the nature and complexity of the entity.

.16 In evaluating the design of the entity risk assessment component and determining whether it has been implemented, the auditor should understand whether management defines objectives clearly in specific and measurable terms to enable the design of internal control for related risks to be understood at all levels of the entity. Within the objectives, management defines the risk tolerances, which are the acceptable levels of variation in performance relative to the achieving objectives. Depending on the category of objectives, risk tolerances may be expressed as operations objectives, nonfinancial reporting objectives, financial reporting objectives, or compliance objectives (Green Book 6.02–6.10).

.17 If the auditor identifies risks of material misstatement that management failed to identify, the auditor should

- determine whether any such risks are of a kind that the auditor expects would have been identified by the entity's risk assessment process and, if so, obtain an understanding of why the entity's risk assessment process failed to identify such risks of material misstatement and
- consider the implications for the auditor's evaluation of whether the entity's risk assessment process is appropriate to the entity's circumstances (AU-C 315.23).

Information and Communication

.18 The auditor should evaluate the design of the information and communication component and determine whether it has been implemented.[29] Management uses quality information to support the internal control system. Effective information and communication are vital for an entity to achieve its objectives. Entity management needs access to relevant and reliable communication related to internal as well as external events. The underlying principles for this component are as follows (Green Book):

[29]The "information and communication component" discussed in the FAM is referred to as the information system and communication component in AU-C 315.

- Management should use quality information to achieve the entity's objectives.
- Management should internally communicate the necessary quality information to achieve the entity's objectives.
- Management should externally communicate the necessary quality information to achieve the entity's objectives.

.19 Management identifies information requirements needed to achieve the entity's objectives and to address related risks. Based on the identified information requirements, management obtains relevant data from reliable internal and external sources in a timely manner. Management processes relevant data into quality information, within the entity's information system, that supports the internal control system. Management uses quality information to make informed decisions and evaluate the entity's performance in achieving key objectives and addressing risks. Quality information is appropriate, current, complete, accurate, accessible, and provided on a timely basis (Green Book 13.02–.06).

.20 Communication includes providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting. It includes the extent to which personnel understand how their activities relate to the work of others and the means of reporting exceptions to an appropriate higher level within the entity. Management communicates quality information down and across reporting lines to enable personnel to perform key roles in achieving objectives, addressing risks, and supporting the internal control system. Open communication channels provide a means to report exceptions to the appropriate people, including management and those charged with governance (Green Book 14.02–14.06).

.21 Management communicates with, and obtains quality information from, external parties using established reporting lines so that external parties can help the entity achieve its objectives and address related risks. Open two-way external reporting lines allow for this communication. Information communicated to management and those charged with governance includes significant matters relating to risks, changes, or issues that impact the entity's internal control system (Green Book 15.02–15.06 and 13.02).

.22 Management considers a variety of factors, such as audience, nature of information, availability, cost, and legal or regulatory requirements, in selecting an appropriate method of communication. Communication takes such forms as websites, emails, policy manuals, accounting and financial reporting manuals, and memorandums. Communication also may be electronic, oral, and through the actions of management in demonstrating acceptable behavior (Green Book 14.07–14.08). Laws and regulations may require entities to establish separate lines of communication, such as whistleblower and ethics hotlines, for communicating confidential information. Management informs employees of these separate reporting lines, how they operate, how they are to be used, and how the information will remain confidential (Green Book 14.06).

.23 Based on AU-C 315.25a and .42b, the auditor should, through performing risk assessment procedures, obtain and document an understanding of the information and communication component and the underlying principles, relevant to the preparation of the financial statements. In connection with this understanding, the auditor should obtain an understanding of the entity's information system, including its information processing and data, the resources

to be used in such activities and the policies that define, for material line items, accounts, note disclosures, and classes of transactions,

a. how information flows through the entity's information system, including how

- transactions are initiated, and how information about them is recorded, processed, corrected as necessary, incorporated into the general ledger, and reported in the financial statements and
- information about events and conditions, other than transactions, is captured, processed, and disclosed in the financial statements;

b. the accounting records, specific accounts in the financial statements, and other supporting records relating to the flows of information in the information system;

c. the financial reporting process used to prepare the entity's financial statements, including note disclosures; and

d. the entity's resources, including information technology,[30] relevant to the preceding items.

.24 The auditor should also obtain an understanding of the entity's information system as it relates to accounting estimates, including the following (AU-C 540.12h:

a. How information relating to accounting estimates and related note disclosures for material line items, accounts, note disclosures, and classes of transactions flows through the entity's information system.

b. For such accounting estimates and related note disclosures, how management

- identifies the relevant methods, assumptions, or sources of data, and the need for changes in them, that are appropriate in the context of the applicable financial reporting framework (generally U.S. GAAP), including how management
  - selects or designs, and applies, the methods used, including the use of models,
  - selects the assumptions to be used, including consideration of alternatives, and identifies significant assumptions, and
  - selects the data to be used;
- understands the degree of estimation uncertainty, including by considering the range of possible measurement outcomes; and
- addresses the estimation uncertainty, including selecting a point estimate and related note disclosures for inclusion in the financial statements.

.25 Based on AU-C 315.25b, the auditor should obtain an understanding of how the entity communicates significant matters that support the (1) preparation of the financial statements, including safeguarding of assets and compliance with laws

[30]This includes the information technology applications and supporting information technology infrastructure, as well as the information technology processes and personnel involved in those processes, that an entity uses to support its operations and achieve strategic objectives.

(including those governing the use of budget authority), regulations, contracts, and grant agreements, and (2) related responsibilities in the information and communication component and other components of internal control

- between people within the entity, including how financial reporting roles and responsibilities are communicated;
- between management and those charged with governance; and
- with external parties, such as those with regulatory authorities and service organizations.

.26 The auditor should evaluate, based on the auditor's understanding obtained in the preceding paragraphs, whether the entity's information and communication component appropriately supports the preparation of the entity's financial statements in accordance with the applicable financial reporting framework (generally U.S. GAAP), considering the nature and complexity of the entity (AU-C 315.25c).

Monitoring

.27 The auditor should evaluate the design of the monitoring component and determine whether it has been implemented. Internal control monitoring assesses the quality of performance over time and promptly resolves the findings of audits and other reviews. Corrective actions are a necessary complement to control activities in order to achieve objectives. The underlying principles for this component are as follows (Green Book):

- Management should establish and operate monitoring activities to monitor the internal control system and evaluate the results.
- Management should remediate identified internal control deficiencies on a timely basis.

.28 Monitoring is the process by which management and those charged with governance assess the effectiveness of internal control performance over time. This may include establishing a baseline; ongoing activities, such as regular management and supervision, to determine that a control was performed correctly and evaluating the results; or communications from external parties, such as regulator comments that may indicate areas in need of improvement (Green Book 16.02–16.03).

.29 Monitoring may include separate evaluations, such as FMFIA and FFMIA assessments and IG or internal auditor work, or a combination of ongoing activities and separate evaluations (see FMFIA and FFMIA sections below for further discussion). Ongoing monitoring is built into the entity's operations, is performed continually, and responds to change. Separate evaluations are used periodically and may provide feedback on the effectiveness of ongoing monitoring. Separate evaluations also include audits and other evaluations that may involve the review of control design and direct testing of internal control. Management evaluates and documents the results of ongoing monitoring and separate evaluations to identify internal control issues (Green Book 16.04–16.09).

.30 Some entities have an internal audit function, which is often an important part of monitoring. Internal audit (1) provides information about the functioning of

internal control, focusing considerable attention on evaluating the effectiveness of internal control; (2) communicates information about strengths and deficiencies in internal control; and (3) provides recommendations for improving internal control. If the internal audit function is part of the entity's monitoring controls, the auditor should understand the design and implementation of the internal audit function as a monitoring control. Understanding an internal audit function includes considering its authority and reporting relationships, the qualifications of its staff, and its resources. For information on using the work of internal auditors, see FAM 645.

.31 Monitoring activities may include using information from communications from external parties that may indicate problems or highlight areas in need of improvement. For example, management may use information from the IG's office to aid in monitoring. The IG's office (a) conducts audits and investigations relating to programs and operations; (b) provides oversight and coordination, including recommending policies for programs and operations; and (c) keeps the entity head and the Congress informed about problems and deficiencies, including the progress of corrective actions. If using information from the IG's office is part of the entity's monitoring controls, the auditor should understand the design and implementation of this as a monitoring control (Green Book 16.10).

.32 Effective monitoring includes evaluating any internal control deficiencies identified and remediating those deficiencies timely. This may be accomplished through establishing reporting lines to the appropriate internal and external parties on a timely basis to enable prompt evaluation of those issues. For example, personnel may communicate these issues internally to the person in the key role responsible for the internal control or associated process and, when appropriate, to at least one level of management above that individual. Depending on the nature of the issues, personnel may consider reporting certain issues to those charged with governance. Management determines based on the type of internal control deficiency the appropriate corrective actions to remediate the internal control deficiency on a timely basis (Green Book 17.01–17.05). This includes completing and documenting the corrective actions on a timely basis. These corrective actions include resolution of audit findings (Green Book 17.06).

.33 Based on AU-C 315.24 and .42b, the auditor should, through performing risk assessment procedures, obtain and document an understanding of the monitoring component and the underlying principles, relevant to the preparation of the financial statements, by

a. understanding those aspects of the entity's process that address

   - ongoing and separate evaluations for monitoring the effectiveness of controls, including safeguarding controls and controls over compliance with laws (including those governing the use of budget authority), regulations, contracts, and grant agreements, and the identification and remediation of control deficiencies identified and

   - the entity's internal audit function, if any, including its nature, responsibilities, and activities.

b. understanding the sources of the information used in the entity's process to monitor internal control, and the basis upon which management considers the information to be sufficiently reliable for the purpose.

c. evaluating, based on the auditor's understanding obtained above, whether the entity's process for monitoring internal control is appropriate to the entity's circumstances considering the nature and complexity of the entity.

Control Activities

.34 Control activities are the actions management establishes through policies and procedures to achieve objectives and respond to risks in the internal control system, which includes the entity's information system. The underlying principles for this component are as follows (Green Book):

- management should design the entity's control activities to achieve objectives and respond to risks,
- management should design the entity's information system and related control activities to achieve objectives and respond to risks, and
- management should implement control activities through policies.

.35 Based on AU-C 315.26, the auditor should, through performing risk assessment procedures, obtain and document an understanding of the control activities component and the underlying principles relevant to the preparation of the financial statements. The auditor's understanding of specific control activities is obtained in the internal control phase and discussed in FAM 300. In the planning phase, the auditor may obtain an understanding of the control activities component through inquiries with management regarding any changes in this component from the prior year and review of high-level documents that the entity has prepared related to control activities.

Effect of Information Technology on Internal Control

.36 The auditor should obtain an understanding of the entity's information technology environment sufficient for assessing the risks of material misstatement and planning the audit. The information technology environment consists of the information technology applications and supporting information technology infrastructure, as well as the information technology processes and personnel involved, that an entity uses to support its operations and achieve strategic objectives (AU-C 315.12). The auditor should identify aspects of the entity's information technology environment relevant to material line items, accounts, note disclosures, and classes of transactions that are subject to risks arising from the use of information technology.

.37 The information technology environment affects the effectiveness of the five components of internal control. For example, controls that normally would be performed by separate individuals in manual systems may be concentrated in one software program or application and pose a potential segregation-of-duties issue. See AU-C 315.A278 for further discussion of the effect of information technology on internal control.

.38 The auditor should evaluate the following factors in assessing the effect of information technology on the five components of internal control. An IS controls auditor may assist the auditor in considering these factors.

a. **Management's attitudes and awareness with respect to information technology.** Management's interest in and awareness of information technology functions (including those performed for the entity by other

organizations) is important in establishing an organization-wide consciousness of control issues. Management may demonstrate its interest and awareness by

- considering the risks and benefits of software programs;
- communicating policies regarding information technology functions and responsibilities;
- overseeing policies and procedures for developing, modifying, maintaining, and using computers, and for controlling access to programs and files;
- considering the risks of material misstatement, including fraud risk, related to information technology;
- responding to previous recommendations or concerns;
- quickly and effectively planning for, and responding to, information technology crises; and
- using reliable computer-generated information for key operating decisions.

b. **Organization and structure of the information technology function.** The organizational structure of the information technology function affects the control environment. Centralized structures often have a single computer-processing organization and use a single set of system and software programs, enabling tighter management control over information technology. In decentralized structures, each computer center generally has its own computer-processing organization, software programs, and system software, which may result in differences in policies and procedures and various levels of compliance at each location.

c. **Clearly defined assignment of responsibilities and authority.** Appropriate assignment of responsibility according to typical information technology functional areas can affect the control environment. Factors to consider include

- how the position of Chief Information Officer fits into the organizational structure;
- whether duties are appropriately segregated within the information technology function, such as those of operators and programmers, since lack of segregation typically affects all systems;
- the extent to which management external to the information technology function is involved in major systems development decisions; and
- the extent to which information technology policies, standards, and procedures are documented, understood, followed, and enforced.

d. **Management's ability to identify and to respond to potential risk.** Information technology, by its nature, introduces additional risk factors. The entity should be aware of these risks and should develop appropriate policies and procedures to respond to any information technology issues that might occur. The auditor may evaluate

- the methods for monitoring incompatible functions and for enforcing segregation of duties and
- management's mechanism for identifying and responding to unusual or exceptional conditions timely.

Federal Managers' Financial Integrity Act of 1982[31]

.39 FMFIA requires executive agencies to establish internal controls that reasonably ensure that

- obligations and costs comply with applicable law;
- all assets are safeguarded against waste, loss, unauthorized use, and misappropriation; and
- revenues and expenditures applicable to agency operations are recorded and accounted for properly so that accounts and reliable financial and statistical reports may be prepared and accountability of the assets may be maintained.

The Comptroller General issues standards for internal control in the federal government pursuant to FMFIA. GAO's *Standards for Internal Control in the Federal Government* (Green Book) provides the overall framework for establishing and maintaining an effective internal control system and provides management criteria for designing, implementing, and operating an effective internal control system.

.40 FMFIA also requires executive agencies to evaluate and report on whether the agencies' internal control systems comply with the requirements described in the paragraph above. OMB Circular No. A-123, *Management's Responsibility for Enterprise Risk Management and Internal Control*, provides implementation guidance for complying with this requirement. The circular defines management's responsibilities related to internal control and the process for assessing and reporting on the effectiveness of internal control over operations, reporting, and compliance.

.41 If applicable to the entity, the auditor should obtain an understanding of the entity's process for assessing and reporting on the effectiveness of internal control based on criteria established under FMFIA (referred to as the FMFIA process) and whether the process has been implemented. The auditor should then determine whether this understanding affects the auditor's risk assessment.

.42 The effectiveness of the FMFIA process typically is a good indicator of management's (1) philosophy and operating style, (2) assignment of authority and responsibility, and (3) control methods for monitoring and follow-up. The FMFIA process also may be the basis for management's assessment about the effectiveness of internal control over financial reporting and about the entity's financial management systems' substantial compliance with FFMIA requirements.

[31]FMFIA was repealed, but provisions remain codified at 31 U.S.C. § 3512(c), (d). These provisions are still commonly referred to as FMFIA. Because of the common usage of the act's name, the FAM will continue to refer to FMFIA. However, auditors should correctly cite the applicable provisions in their reports. See FAM 595 A.

.43 To obtain an understanding of the FMFIA process, the auditor generally should perform the following procedures. If the entity does not issue its own FMFIA report, the auditor generally should perform the following procedures with respect to information the entity contributes to the FMFIA report in which the entity is included.

a. Read the following:

- FMFIA reports for the current and prior years to identify any changes;
- important documentation prepared by the entity to support the current-year FMFIA report and related management assertions in the Management's Discussion and Analysis (MD&A);
- any IG reports on the FMFIA process;
- OMB's most recent annual letter concerning FMFIA reporting; and
- management's description of the FMFIA process.

b. Discuss the FMFIA process with appropriate entity management (including management's opinion of the quality of the process), specifically

- how the FMFIA process is organized;
- who is assigned to manage the process, including the staffing level, experience and qualifications of assigned personnel, and reporting responsibilities; and
- how the process finds and evaluates deficiencies.

c. Identify the entity's actions on previously reported deficiencies and examine its documentation that demonstrates the results/effectiveness of those actions.

d. Determine whether the audit finds different issues from those identified in the FMFIA process (if so, see FAM 580.85 for reporting on FMFIA).

.44 The auditor should consider whether management procedures and supporting documentation are designed to provide management with reasonable assurance that FMFIA objectives have been achieved. The auditor's consideration is based on the auditor's understanding of the procedures discussed above rather than the results of extensive tests. Factors the auditor may consider include

- evidence of efforts to rectify previously identified material weaknesses;
- management's commitment of resources to the FMFIA process, as reflected in the skills, objectivity, and number of personnel assigned to manage the process;
- extent to which management's methodology and assessment process, including testing and documentation, conform to the guidance in OMB Circular No. A-123 and related appendixes;
- contractor or internal auditor involvement (if any);
- the process used to identify and screen material weaknesses as FMFIA reports are consolidated and moved up the entity's hierarchy;
- the sources that identify material weaknesses, since items identified by management personnel, rather than information from IG, GAO, or other

external reports, demonstrate that the process can detect and report deficiencies;

- the extent to which management's FMFIA reports are consistent with the auditor's findings; and
- risk factors in FAM 295 B.20.

.45 The auditor should document the understanding of the FMFIA process and its implementation. Based on this understanding, the auditor should determine whether this understanding affects the auditor's risk assessment. The auditor should consider any material weaknesses identified in the FMFIA report in assessing the risks of material misstatement.

The auditor is not required to test the effectiveness of the FMFIA process. However, the auditor may determine that it is appropriate to test management's FMFIA work to reduce audit risk. The auditor's determination, based on testing, that FMFIA is an effective control may reduce but cannot completely eliminate the need for the auditor to perform substantive procedures for material line items, accounts, note disclosures, and classes of transactions. FAM 360 discusses control testing, and FAM 370 discusses the preliminary assessments of control risk and the risk of material misstatement.

Internal Control over Financial Reporting

.46 The auditor should obtain an understanding of the entity's process for assessing the effectiveness of its internal control over financial reporting. Management is responsible for the design, implementation, and maintenance of internal control over financial reporting. An entity should have a reasonable basis supporting management assertions on the effectiveness of internal control over financial reporting. As discussed in the Green Book, an effective internal control system has

- each of the five components of internal control designed, implemented, and operating effectively and
- the five components operating together in an integrated manner.

.47 In order to obtain an understanding of the entity's system of internal control over financial reporting, the auditor may perform the following procedures:

- Determine whether the entity established and organized an appropriate internal control over financial reporting management team.
- Determine whether the entity documented its methodology and plan for its internal control over financial reporting process, including an entity risk assessment.
- Review documentation from the entity's prior assessments of internal control over financial reporting.

.48 In obtaining an understanding, the auditor should consider whether management procedures and supporting documentation are designed to provide management with reasonable assurance about the effectiveness of the entity's internal control over financial reporting. This consideration should include risk factors in FAM 295 B.21.

The auditor should consider any material weaknesses identified by management's assessment of internal control over financial reporting in determining the risks of material misstatement. FAM 270 discusses determining the likelihood of effective information system controls (IS controls), FAM 360 discusses control testing, and FAM 370 discusses the preliminary assessments of control risk and the risk of material misstatement.

Federal Financial Management Improvement Act of 1996

.49 As part of its FFMIA work, management determines whether its financial management systems adhere to the guidance found in OMB Circular No. A-123, appendix D, *Management of Financial Management Systems – Risk and Compliance*, and the *Treasury Financial Manual,* volume 1, part 6, chapter 9500, *Revised Federal Financial Management System Requirements*. Under FFMIA, the auditor of CFO Act agencies must report whether the financial management systems comply substantially with the three requirements of the act. OMB issues guidance for agencies and auditors when addressing compliance with FFMIA. FAM 701 contains additional guidance for auditors.

.50 During the planning phase, the auditor should understand the design of management's process for determining whether the entity's financial management systems were in substantial compliance to report under FFMIA. OMB Circular No. A-123 and the *Treasury Financial Manual* provide criteria for assessing FFMIA compliance. The auditor generally should read management's documentation to determine whether to rely on the entity's work. If reliance is planned, see FAM 645. See FAM 350 for additional planning of audit procedures related to FFMIA.

.51 If the entity previously had an assessment made of its financial management systems' substantial compliance with these requirements that resulted in finding lack of substantial compliance, the auditor should understand the systems deficiencies identified and consider their effect on the risks of material misstatement. The auditor also should read the remediation plan required by FFMIA and note whether the plan appears feasible and likely to remedy the deficiencies.

Federal Information Security Modernization Act of 2014

.52 The Federal Information Security Modernization Act of 2014 (FISMA) amended the Federal Information Security Management Act of 2002. FISMA requires federal agencies to periodically test, evaluate, and report on the effectiveness of their information security policies, procedures, and practices as part of developing and implementing an entity-wide information security program. FISMA requires agencies to use the National Institute of Standards and Technology's (NIST) standards when performing certain functions. OMB reporting guidance for FISMA specifies the applicable NIST standards and other NIST publications to be used.

.53 FISMA requires agencies to perform an independent evaluation and submit an annual report regarding major information security incidents to OMB, the Department of Homeland Security, and GAO. These annual reports should include (1) threats and threat actors, vulnerabilities, and impacts; (2) agency risk assessments of affected systems before, and the status of compliance of the systems with security requirements at the time of, major incidents; (3) detection,

response, and remediation actions; (4) the total number of incidents, including system implementation levels and locations of affected incidents; and (5) a description of the number of individuals affected by, and the information exposed by, major incidents involving a breach of personally identifiable information. Agencies are also required to have their information security programs evaluated each year by their IG or by an independent external auditor. An external auditor may be engaged by an IG or, if the agency does not have an IG, by the agency. Management may rely on testing performed as part of the independent evaluation when making its own assessment.

.54 The auditor should read the most recent FISMA report to assess the implications of any reported threats, incidents, and vulnerabilities on the risks of material misstatement. The auditor may assess whether the procedures performed for FISMA reporting can be relied upon as part of the financial statement audit for purposes of planning and conducting other audit procedures. Likewise, it may be possible for the auditor to use procedures performed as part of the financial statement audit to fulfill the FISMA requirements for certain systems, depending on the timing, nature, and extent of the work.

Budget Formulation

.55 The auditor should obtain an overall understanding of the design of the budget formulation process. The auditor does this to understand better how misstatements and internal control deficiencies may affect the budget formulation process. Based on discussions with entity management responsible for the budget formulation process and review of budget documents, the auditor should understand the design of

- the entity's process for developing and summarizing the budget;
- the nature and sufficiency of instructions and training provided to individuals responsible for developing the budget;
- the extent to which individuals involved in approving budget requests are also involved in the budget formulation process;
- the general extent to which the budget is based on historical information;
- the reliability of information on which the budget is based;
- the extent to which the budget formulation system is integrated with the budget execution system; and
- the correlation between information developed in the budget formulation process and the allotments and suballotments, if applicable, in the budget execution system.

.56 The auditor is not required to test the effectiveness of the budget formulation process, unless the auditor determines in the internal control phase that testing the effectiveness of the budget formulation process is an efficient and effective means of reducing the risk of material misstatement and the extent of substantive procedures.

265 – Identify Risks of Material Misstatement and Assess Inherent Risk

Audit Risk

.01 AU-C 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*, provides guidance on audit risk and defines it as the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is composed of the following risks:

a. **Risk of material misstatement** is the risk that prior to the audit, the financial statements are materially misstated due to fraud or error. The components of risk of material misstatement are described below.

- **Inherent risk** is the susceptibility of an assertion about a line item, account, note disclosure, or class of transactions to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related control activities (AU-C 200.14).
- **Control risk** is the risk that a misstatement that could occur in an assertion about a line item, account, note disclosure, or class of transactions and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control (AU-C 200.14). Control risk is a function of the effectiveness of the design and operation of internal control in achieving the entity's objectives relevant to preparation and fair presentation of the entity's financial statements. Some control risk will always exist because of the inherent limitations of internal control.

b. **Detection risk** is the risk that the procedures the auditor performs to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements (AU-C 200.14). Detection risk is a function of the effectiveness of an audit procedure and of its application by the auditor (AU-C 200.A50). Detection risk relates to the substantive procedures and is managed by the auditor's response to the risk of material misstatement.

.02 To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, the auditor should obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion (AU-C 200.06 and .19).

.03 Audit assurance is the complement of audit risk and equals 100 percent minus the allowable audit risk.[32] The audit organization should determine the audit assurance to use, which may vary between audits based on risk. GAO auditors

[32]Audit assurance is not the same as statistical confidence. Audit assurance is a combination of quantitative measurement and auditor judgment.

should use an audit assurance of 95 percent. In other words, the GAO auditor, in order to provide an opinion, should design the audit to achieve at least 95 percent audit assurance that the financial statements are not materially misstated (5 percent audit risk). FAM 470 provides guidance on how to combine (1) the risk of material misstatement and (2) detection risk for substantive procedures to achieve the audit assurance required by the audit organization.

.04 The auditor may consider it necessary to achieve increased audit assurance if the entity is politically sensitive or if the Congress has expressed concerns about the entity's financial reporting. In these cases, the basis for the increased level of audit assurance must be provided to the reviewer in a timely manner to allow any issues to be promptly identified and resolved.

.05 Based on the level of audit risk and the risk of material misstatement, the auditor should determine the nature, extent, and timing of substantive procedures necessary to achieve the acceptable level of detection risk. For example, in response to a high risk of material misstatement, the auditor may perform

- additional substantive procedures that provide more appropriate evidence (nature of procedures);
- more extensive substantive procedures (extent of procedures), as discussed in FAM 295 E; or
- substantive procedures at or closer to the financial statement date (timing of procedures).

Brainstorming About the Risks of Material Misstatement

.06 The engagement partner (typically the audit director) and other key engagement team members should discuss (brainstorm about) the application of the applicable financial reporting framework (generally U.S. GAAP) and the susceptibility of the entity's financial statements to material misstatement (AU-C 315.17). The discussion accomplishes the following (AU-C 315.A49):

- Provides an opportunity for more experienced engagement team members, including the engagement partner, to share their insights based on their knowledge of the entity. Sharing information contributes to an enhanced understanding by all engagement team members.
- Allows the engagement team members to exchange information about the risks to which the entity is subject; how inherent risk factors may affect the susceptibility of line items, accounts, note disclosures, and classes of transactions to misstatement; and about how and where the financial statements might be susceptible to material misstatement due to fraud or error.
- Assists the engagement team members in gaining a better understanding of the potential for material misstatement of the financial statements in the specific areas assigned to them and to understand how the results of the audit procedures that they perform may affect other aspects of the audit, including the decisions about the nature, timing, and extent of further audit procedures. In particular, the discussion assists engagement team members in further considering contradictory information based on each member's own understanding of the nature and circumstances of the entity.

- Provides a basis on which engagement team members communicate and share new information obtained throughout the audit that may affect the assessment of risks of material misstatement or the audit procedures performed to address these risks.

Depending on the circumstance of the audit, multiple discussions may be held to facilitate the ongoing exchange of this information among team members. The purpose of these discussions is to share information obtained throughout the audit that may affect the auditor's risk assessments or related audit procedures.

.07 As required by AU-C 240.15, this discussion should include an exchange of ideas, or brainstorming, among the engagement team members about how and where the entity's financial statements (including the individual statements and note disclosures) might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated. During the discussion, engagement team members should set aside beliefs that they may have that management and those charged with governance are honest and have integrity, and should, in particular, also address

- known external and internal factors affecting the entity that may create an incentive or pressure for management or others to commit fraud, provide the opportunity for fraud to be perpetrated, and indicate a culture or environment that enables management or others to rationalize committing fraud;
- the risk of management override of controls;
- consideration of circumstances that might be indicative of earnings management or manipulation of other financial measures and the practices that might be followed by management to manage earnings or other financial measures that could lead to fraudulent financial reporting;
- the importance of maintaining professional skepticism throughout the audit regarding the potential for material misstatement due to fraud (see FAM 110.25); and
- how the auditor might respond to the susceptibility of the entity's financial statements to material misstatement due to fraud (AU-C 240.15).

.08 During the brainstorming, the auditor should include specific consideration of the susceptibility of the financial statements to material misstatement due to error or fraud that could result from the entity's relationships and transactions with disclosure entities, related parties, and public-private partnerships (AU-C 550.13). The auditor may discuss matters such as (1) the nature and extent of these relationships and transactions; (2) the records or documents that may indicate the existence of these relationships or transactions; and (3) how disclosure entities, related parties, and public-private partnerships may be involved in fraud. See AU-C 550.A7 through .A8 for additional matters that may be discussed.

.09 Key members of the engagement team should be involved in this discussion; however, it is not necessary for all team members to have a comprehensive knowledge of all aspects of the audit. The auditor should use professional judgment to determine the meeting participants (including any specialists), the number of meetings, how and when the meetings should occur, and the extent of

the discussion. The roles, experience, and information needs of the engagement team are factors that influence the extent of the discussion.

.10 When there are engagement team members not involved in the engagement team discussion, the engagement partner should determine which matters to communicate to those members (AU-C 315.18). For example, if separate discussions are held with the key staff at various locations for a multilocation audit, it is not necessary for all members of the engagement team to be informed of all the decisions reached in the discussion.

Identify Risks of Material Misstatement

.11 The auditor should identify the risks of material misstatement due to fraud or error and determine whether they exist at the

a. financial statement level or

b. assertion level for line items, accounts, note disclosures, and classes of transactions (AU-C 315.32).

A risk of material misstatement exists when

- there is a reasonable possibility of a misstatement occurring (i.e., its likelihood) and
- if it were to occur, there is a reasonable possibility of the misstatement being material (i.e., its magnitude).

There is a reasonable possibility when the likelihood of a material misstatement occurring is more than remote. (AU-C 315.A12)

Risks of Material Misstatement at the Financial Statement Level

.12 Risks of material misstatement at the financial statement level relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of this nature are not necessarily risks identifiable with specific assertions at the line item, account, note disclosure, or class of transactions level. Rather, they represent circumstances that may pervasively increase the risks of material misstatement at the assertion level. (AU-C 315.A224) Risks of material misstatement at the financial statement level affect the auditor's design of overall responses, as discussed in FAM 420 and AU-C 330.A1 through .A2, including an influence on the nature, timing, and text of further audit procedures (AU-C 315.A114).

.13 Based on AU-C 315.A225 through .A227, the auditor should consider the following in identifying risks of material misstatement at the financial statement level:

- risks related to the political climate, public interest, and sensitivity of programs or activities;
- fraud risks, including management override of control; and
- risks related to the entity's internal control, in particular, the control environment, entity risk assessment, information and communication, and monitoring components (see FAM 260).

.14 Based on AU-C 315.A275, events or conditions that may indicate risks of material misstatement at the financial statement level include

- lack of personnel with appropriate accounting and financial reporting skills;
- past misstatements, history of errors, or a significant amount of adjustments at period-end; and
- control deficiencies, particularly in the control environment, entity risk assessment, information and communication, and monitoring components, and especially those not addressed by management (see FAM 260).

  Deficiencies in the operation of these four components could have pervasive effects on the preparation of the financial statements because these components are foundational to the entity's internal control.

Risks of Material Misstatement at the Assertion Level

.15 Risks of material misstatement at the assertion level are those that do not relate pervasively to the financial statements (AU-C 315.A231). For each applicable assertion in each material line item, account, note disclosure, and class of transactions identified in FAM 235, the auditor should identify the related risks of material misstatement.

.16 Based on the auditor's understanding of the entity and its environment, the applicable financial reporting framework (generally U.S. GAAP), and the entity's accounting policies, the auditor should tailor the potential misstatements in FAM 395 B to the specific circumstances of the entity. The auditor may identify multiple types of potential misstatements in an assertion. Some types of potential misstatements may affect only a portion or component of a line item, account, note disclosure, or class of transactions. These potential misstatements represent identified risks of material misstatement at the assertion level.

.17 The auditor should document the identified risks of material misstatement at the assertion level for each material line item, account, note disclosure, and class of transactions on the LIRA form at FAM 395 H or equivalent.

.18 The auditor may conclude that some risks of material misstatement identified at the assertion level relate more pervasively to the financial statements as a whole and potentially affect many assertions, in which case, the auditor may update the identification of risks of material misstatement at the financial statement level (AU-C 315.A245).

Assess and Respond to Risks of Material Misstatement at the Financial Statement Level

.19 For identified risks of material misstatement at the financial statement level, the auditor should assess the risks and

- determine whether they affect the assessment of risks at the assertion level and
- evaluate the nature and extent of their pervasive effect on the financial statements (AU-C 315.34).

For example, management override of controls is a risk that resides at the financial statement level but may also relate to the overstatement of revenue.

.20 The auditor should design and implement overall responses to address the risks of material misstatement at the financial statement level (AU-C 330.05). See FAM 420.02 for further guidance.

.21 The auditor should document in the audit strategy the identification and assessment of risks of material misstatement at the financial statement level and the overall responses to such risks.

Assess and Respond to Inherent Risk for Identified Risks of Material Misstatement at the Assertion Level

Assess Inherent Risk

.22 For each identified risk of material misstatement at the assertion level, the auditor should assess inherent risk by assessing the likelihood and magnitude of misstatement before consideration of any related control activities.[33] In doing so, the auditor should take into account how, and the degree to which,

a. inherent risk factors identified in FAM 220 affect the susceptibility of assertions to misstatement and

b. the risks of material misstatement at the financial statement level affect the assessment of inherent risk for risks of material misstatement at the assertion level. (AU-C 315.35)

.23 For each identified risk of material misstatement at the assertion level in each material line item, account, note disclosure, and class of transactions, the auditor should assess inherent risk at one of four levels:

- **Remote:** The auditor believes, before consideration of control activities, that the likelihood of a material misstatement occurring in the assertion is less than reasonably possible.
- **Low:** The auditor believes, before consideration of control activities, that it is **unlikely** that any aggregate misstatements in the assertion exceed performance materiality.
- **Moderate:** The auditor believes, before consideration of control activities, that it is **more than unlikely but less than likely** that any aggregate misstatements in the assertion exceed performance materiality.
- **High:** The auditor believes, before consideration of control activities, that it is **likely** that any aggregate misstatements in the assertion exceed performance materiality.

Low, moderate, and high are varying levels of likelihood that are reasonably possible and represent the spectrum of inherent risk.[34] It is rare for the auditor to assess all identified risks of material misstatement for a material line item,

[33]In the FAM, control activities include controls within the control environment, entity risk assessment, information and communication, and monitoring components that directly address risks of material misstatement at the assertion level (see FAM 360.19).

[34]The spectrum of inherent risk refers to the scale on which the level of inherent risk varies (AU-C 315.12). The assessed level of inherent risk for an identified risk of material misstatement at the assertion level represents a judgment within a range, from low to high, on the spectrum of inherent risk (AU-C 315.A239).

account, note disclosure, or class of transactions at remote. If this is the case, the auditor should document justification for such assessment. See AU-C 315.A235 through .A246 for additional guidance on assessing inherent risk.

.24 For each identified risk of material misstatement at the assertion level in each material line item, account, note disclosure, and class of transactions, the auditor should document the inherent risk factors considered in the assessment. For example, the auditor may assess inherent risk at high for an identified risk of material misstatement in the valuation of the net receivables line item due to (1) the materiality of the receivables and potential allowance, (2) the subjectivity of management's judgment related to the loss allowance, and (3) management's history of aggressively challenging any proposed adjustments to the valuation of the receivables. The auditor should also document other considerations regarding the likelihood and magnitude of the misstatement. See FAM 290 for detailed documentation requirements.

Respond to Inherent Risk

.25 For each identified risk of material misstatement at the assertion level for which inherent risk is more than remote, in each material line item, account, note disclosure, and class of transactions, the auditor should

a. perform control tests of relevant control activities (i.e., those the auditor plans to test), to assess control risk and the risk of material misstatement (combined assessment of inherent risk and control risk) and

b. design and perform substantive procedures based on the assessment of risk of material misstatement.

Control tests are discussed in FAM 360. The assessment of control risk and risk of material misstatement is discussed in FAM 370. Substantive procedures are discussed in FAM 470.

.26 In rare circumstances in which the auditor assessed all identified risks of material misstatement at remote for a material line item, account, note disclosure, or class of transactions, the auditor should nonetheless perform substantive procedures for that material line item, account, note disclosure, or class of transactions.[35] Additionally, the auditor should perform control tests, as appropriate, if the auditor is providing an opinion on internal control.

Identify and Respond to Significant Risks

Identify Significant Risks

.27 The auditor should determine whether any of the identified risks of material misstatement for which inherent risk is more than remote, including those related

[35]Based on AU-C 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, the auditor should perform substantive procedures for classes of transactions, account balances, and disclosures for which there is one or more identified risks of material misstatement for which inherent risk is more than remote. The FAM expands on the AU-C 330 requirement to include performing substantive procedures for all material line items, accounts, note disclosures, and classes of transactions. As a result, the stand-back requirement in AU-C 315.40 does not apply.

to accounting estimates, are **significant risks** (AU-C 315.36 and 540.16). A significant risk is an identified risk of material misstatement

a. for which the assessment of inherent risk is high (based on AU-C 315.12);[36]

b. due to fraud, for which inherent risk is more than remote (AU-C 240.27); or

c. arising from transactions with disclosure entities, related parties, and public-private partnerships that are also significant unusual transactions, for which inherent risk is more than remote (AU-C 550.20).

.28 Based on AU-C 315.A251, a significant risk may arise from matters such as

- transactions for which there are multiple acceptable accounting treatments such that subjectivity is involved;
- accounting estimates that have high estimation uncertainty or complex models (for example, pension and post-retirement benefits liability estimates based on actuarial models) (see FAM 260.24);
- accounting for unusual or complex transactions (for example, accounting for revenue with multiple performance obligations that are difficult to value);
- emerging areas (for example, accounting for digital assets);
- complexity in data collection and processing to support account balances;
- account balances or quantitative disclosures that involve complex calculations;
- accounting principles that may be subject to differing interpretation; or
- changes in the entity's operations that involve changes in accounting.

Respond to Significant Risks

.29 If the auditor has determined that a significant risk exists, the auditor should identify the entity's control activities that address such risk and evaluate their design and determine whether they have been implemented (AU-C 240.27, 315.27, and 315.30). As noted in FAM 265.25a, if these control activities are effectively designed and implemented, the auditor should test their operating effectiveness. See FAM 350 and 360 for guidance on performing control tests.

.30 If the auditor has determined that an identified risk of material misstatement at the assertion level is a significant risk, the auditor should perform substantive procedures that are specifically responsive to that risk (AU-C 330.22). In designing substantive procedures, the auditor should obtain more persuasive audit evidence the higher the auditor's assessment of risk (AU-C 330.07b). When the approach to a significant risk consists only of substantive procedures (i.e., because controls are not effective), those procedures should include tests of details (AU-C 330.22). See FAM 470 for further guidance on performing substantive procedures.

[36]AU-C 315 states that an identified risk of material misstatement for which the assessment of inherent risk is close to the upper end of the spectrum of inherent risk is a significant risk. The spectrum of inherent risk per AU-C 315 is the degree to which the level of inherent risk varies. Based on AU-C 315, the FAM considers any identified risks of material misstatement assessed at high to be a significant risk.

.31 As discussed in FAM 215, as part of communicating the planned scope and audit timing with those charged with governance, the auditor should communicate the significant risks that the auditor identified. For audits of group financial statements, see FAM 630 for requirements related to significant risks.

.32 All fraud risks for which inherent risk is more than remote are significant risks. If a significant risk is related to fraud, the auditor should also perform the procedures in FAM 265.38 through .55.

Additional Procedures for Certain Risks

.33 This section discusses additional risk assessment procedures the auditor should perform for the following risks:

a. risks related to accounting estimates;

b. risks related to disclosure entities, related parties, and public-private partnerships; and

c. fraud risks.

Risks Related to Accounting Estimates

.34 As part of the auditor's risk assessment procedures, the auditor should review the outcome of previous accounting estimates or, when applicable, their subsequent reestimation to assist in identifying and assessing the risks of material misstatement in the current period. The auditor should take into account the characteristics of the accounting estimates in determining the nature and extent of that review. The review is not intended to call into question judgments about previous-period accounting estimates that were appropriate based on the information available at the time they were made. (AU-C 540.13)

.35 For accounting estimates, the auditor should determine whether the engagement team requires specialized skills or knowledge to perform the risk assessment procedures, to identify and assess the risks of material misstatement, to design and perform audit procedures to respond to those risks, or to evaluate the audit evidence obtained (AU-C 540.14).

.36 In assessing inherent risk for identified risks of material misstatement relating to an accounting estimate and related note disclosures at the assertion level, the auditor should take the following into account (AU-C 540.15):

a. the degree to which the accounting estimate is subject to estimation uncertainty and

b. the degree to which one or both of the following are affected by complexity, subjectivity, or other inherent risk factors:

- the selection and application of the method, assumptions, and data in making the accounting estimate and
- the selection of management's point estimate and related note disclosures for inclusion in the financial statements.

See FAM 340 and 905 for discussions on accounting estimates related to understanding control activities and performing substantive testing, respectively.

Risks Related to Disclosure Entities, Related Parties, and Public-Private Partnerships

.37 For relationships and transactions with disclosure entities, related parties, and public-private partnerships, unless all of those charged with governance are involved in managing the entity, the auditor's risk assessment procedures should include inquiring of those charged with governance regarding

- their understanding of the entity's relationships and transactions with disclosure entities, related parties, and public-private partnerships that are significant to the entity and
- whether any of those charged with governance have concerns regarding these relationships or transactions and, if so, the substance of those concerns (AU-C 550.16).

Fraud Risks

.38 The auditor should identify and assess the risks of material misstatement due to fraud (fraud risks) at the financial statement level and at the assertion level for line items, accounts, note disclosures, and classes of transactions (AU-C 240.25). The primary factor that distinguishes fraud from error is that the action causing the misstatement in fraud is intentional. For fraud, the auditor's risk assessment should be ongoing throughout the audit (AU-C 240.25). Accordingly, communications among the engagement team members about the risks of material misstatement due to fraud should continue throughout the audit, particularly upon discovery of new facts (AU-C 240.15). As the auditor obtains audit evidence during the audit, the auditor should consider its potential effect on the auditor's assessment of fraud risks.

.39 Two types of misstatements that are relevant to the auditor's consideration of fraud in an audit of financial statements are as follows (Green Book 8.02):

- **Misstatements resulting from fraudulent financial reporting** are intentional misstatements, including omissions of amounts or disclosures in the financial statements, to deceive financial statement users. They could involve intentional alteration of accounting records, misrepresentation of transactions, intentional misapplication of accounting principles, or other means.
- **Misstatements resulting from misappropriation of assets** involve thefts of an entity's assets that result in misstatements in the financial statements. They could involve theft of property, embezzlement of receipts, fraudulent payments, or other means. See FAM 310 for discussion of internal control over safeguarding assets. Safeguarding controls relate to protecting assets against loss from unauthorized acquisition, use, or disposition.

.40 When identifying and assessing the risks of material misstatement due to fraud, the auditor should, based on a presumption that risks of fraud exist in revenue recognition, evaluate which types of revenue, revenue transactions, or assertions give rise to such risks (AU-C 240.26). If the auditor concludes that the presumption is not applicable in the circumstances of the engagement and, accordingly, has not identified revenue recognition as a risk of material misstatement due to fraud, the auditor should document the reasons for that conclusion (AU-C 240.46).

.41 In considering misstatements resulting from misappropriation of assets, the auditor should consider fraud risks associated with improper payments. Some of the improper payments that entities make could involve fraud. The Payment Integrity Information Act of 2019 (PIIA) (Pub. L. No. 116-117), codified in 31 U.S.C. §§ 3351-58, defines an improper payment as any payment that should not have been made or that was made in an incorrect amount (including overpayments and underpayments) under statutory, contractual, administrative, or other legally applicable requirements. This includes any payment to an ineligible recipient, any payment for an ineligible good or service, any duplicate payment, any payment for a good or service not received (except for such payments where authorized by law), and any payment that does not account for credit for applicable discounts.

PIIA also provides that when an entity's review is unable to discern whether a payment was proper as a result of insufficient or lack of documentation, this payment must also be considered an improper payment when identifying programs that might be susceptible to significant improper payments and when producing an estimate of annual improper payments for those identified programs.[37]

PIIA requires entity heads to review all programs and activities that they administer at least once every 3 years and to identify those that might be susceptible to significant improper payments. An entity must produce a statistically valid (or otherwise OMB-approved) estimate of annual improper payments for those identified programs and report those estimates in the accompanying materials to the financial statements. For programs for which an entity reports an estimate of improper payments, the entity head also reports certain corrective actions, such as the entity's plans to reduce and recover improper payments and program-specific improper payment reduction targets. OMB guidance on implementation of this act is included in OMB Circular No. A-123, Appendix C, and OMB Circular No. A-136.

.42 The auditor is not required to perform specific procedures to detect waste or abuse, as the determination of waste and abuse is subjective. Waste is the act of using or expending resources carelessly, extravagantly, or to no purpose. Waste does not necessarily include abuse or illegal acts. Rather, waste relates primarily to mismanagement, inappropriate actions, and inadequate oversight. Abuse is distinct from fraud and illegal acts. Abuse involves behavior that is deficient or improper (but not necessarily fraudulent or illegal) 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 violations of provisions of laws, regulations, contracts, or grant agreements.

Although the auditor is not required to perform procedures to detect waste or abuse, the auditor may consider whether and how to communicate such matters after becoming aware of them. The auditor may discover that the waste or abuse represents potential fraud or noncompliance with provisions of laws, regulations,

[37]Significant improper payments are those that may have exceeded either (1) $10 million and 1.5 percent of program outlays or (2) $100 million regardless of percentage of program outlays.

contracts, and grant agreements that should be addressed following guidance in FAM 540. See GAGAS (2018) 6.20 through 6.24.

Consider Fraud Risk Factors

.43 The auditor should consider fraud risk factors in identifying and assessing the risks of material misstatement due to fraud. Three conditions generally are present when fraud occurs:

a. **Incentive/pressure**—Management, other employees, or external parties (for example, for some improper payments) have an incentive or are under pressure, which provides a motive to commit fraud.

b. **Opportunity**—Circumstances exist, such as the absence of controls, ineffective controls, or the ability of management to override controls, that provide an opportunity to commit fraud.

c. **Attitude/rationalization**—Individuals involved are able to rationalize committing fraud. Some individuals possess an attitude, character, or ethical values that allow them to knowingly and intentionally commit a dishonest act. Generally, the greater the incentive or pressure, the more likely an individual will be able to rationalize the acceptability of committing fraud. (Green Book 8.04)

.44 Although fraud risk factors may not necessarily indicate the existence of fraud, they have often been present in circumstances in which fraud has occurred and therefore may indicate risks of material misstatement due to fraud (AU-C 240.24). While fraud risk may be greatest when all three conditions listed above are present, one or more of these conditions may indicate fraud risk. Other information that internal and external parties provide can also be used to identify fraud risks (Green Book 8.05). Examples of fraud risk factors, classified by the two types of fraudulent misstatements and then by these three conditions, are listed below. FAM 295 A and 295 B include additional examples of fraud risk factors.

a. Examples related to misstatements resulting from fraudulent financial reporting:

- **Incentive/pressure**—Incentive exists for management to report reduced program costs or costs that are consistent with budgeted amounts, or excessive pressure exists to meet unrealistic deadlines, goals, or other requirements.
- **Opportunity**—Key financial statement amounts are based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate, or management is in a position to override controls for processing adjustments or unusual transactions.
- **Attitude/rationalization**—Employees perceive that penalties exist for reporting honest results, or employees consider requirements such as performance targets unrealistic.

b. Examples related to misstatements resulting from misappropriation of assets:

- **Incentive/pressure**—Employees who are disgruntled because of impending layoffs have an incentive to misappropriate assets, or employees under pressure to meet programmatic objectives, such as for

rapid benefit payments, increases the risk of fraudulent improper payments.

- **Opportunity**—Employees have access to assets that are small in size and value or have the authority to disburse funds, or a program has deficiencies in internal control related to fraudulent improper payments.
- **Attitude/rationalization**—Employees believe that management is unethical, or individuals believe they are entitled to the entity's assets.

Obtain Information for Identifying Fraud Risks

.45 To obtain information for use in identifying fraud risks, the auditor should inquire of management about (AU-C 240.17–.18)

a. any knowledge of actual, suspected, or alleged fraud affecting the entity (including fraudulent improper payments);

b. management's assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent, and frequency of such assessments;

c. management's process for identifying, responding to, and monitoring the risks of fraud in the entity, including

- any specific risks of fraud that management has identified or that have been brought to its attention,
- the line items, accounts, note disclosures, and classes of transactions for which a risk of fraud is likely to exist, and
- any fraudulent improper payments that the entity identified in making assessments related to PIIA (Green Book 8.06);

d. management's communication, if any, to employees regarding its views on business practices and ethical behavior;

e. management's communication, if any, to those charged with governance, such as an audit committee (referred to as a financial management advisory committee in some entities) or others with equivalent authority and responsibility, regarding its processes for identifying and responding to the risks of fraud in the entity; and

f. whether the entity has entered into any significant unusual transactions and, if so, the nature, terms, and business purpose (or the lack thereof) of those transactions and whether such transactions involved disclosure entities, related parties, or public-private partnerships.

Inquiries of management and others within the entity are generally most effective when they involve a discussion. The auditor may also find it helpful to provide the interviewee with specific questions and obtain written responses in advance of the discussion.

.46 In addition to inquiring of management, inquiring of others may provide a different perspective or other important information. Accordingly, the auditor should perform the following inquiries and related procedures:

a. Obtain information about instances of fraud (including any related to fraudulent improper payments) that the IG reported, ordinarily by asking the

Special Investigator Unit to summarize how cases of reported fraud were committed, and then ask management or the IG's office whether related controls have been strengthened.

b. Unless all of those charged with governance are involved in managing the entity, the auditor should do the following:

- Obtain an understanding of how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity and the controls that management has established to mitigate these risks (AU-C 240.20 and Green Book 8.06–8.07). This may include understanding whether those charged with governance have established a process for evaluating employees' adherence to the organization's standards of conduct and remediate any deviations timely and consistently (Green Book 1.10).
- Inquire of those charged with governance to determine their views about the risks of fraud; whether they have knowledge of any actual, suspected, or alleged fraud affecting the entity; and whether the entity has entered into any significant unusual transactions. These inquiries are made, in part, to corroborate the responses received from the inquiries of management (AU-C 240.21).
- Inquire of those charged with governance to determine how they identify changes that could significantly impact the entity's internal control system and whether they can identify, on a timely basis, internal and external conditions that have already occurred or are expected to occur (Green Book 9.02–9.03).
- Inquire of those charged with governance to determine whether management performs an entity risk assessment to identify, analyze, and respond to any new risks prompted by changes as part of analyzing and responding to change. This may also include understanding how management analyzes and responds to identified changes and related risks in order to maintain an effective internal control system (Green Book 9.04 and 9.05).

c. Inquire of appropriate individuals within the internal audit function, if any, to obtain their views about the risks of fraud; determine whether they have knowledge of any actual, suspected, or alleged fraud affecting the entity; whether they have performed any procedures to identify or detect fraud during the reporting period; whether management has satisfactorily responded to any findings resulting from these procedures; and whether they are aware that the entity has entered into any significant unusual transactions (AU-C 240.19). See FAM 645 if the auditor plans to use the work of the internal audit function in obtaining audit evidence.

d. Inquire of other personnel to determine if they have knowledge of any actual, suspected, or alleged fraud affecting the entity (AU-C 240.18). The auditor should use judgment to determine whom to ask and the extent of inquiries. For example, the auditor may inquire of employees with varying levels of authority, operating personnel not directly involved in the financial reporting process, employees familiar with complex or unusual transactions or with improper payments, and in-house legal counsel.

When responses to inquiries of management, those charged with governance, or others are inconsistent or otherwise unsatisfactory (for example, vague or implausible), the auditor should further investigate the inconsistencies or unsatisfactory responses (AU-C 240.14).

.47 The auditor also should perform the following procedures:

a. Obtain and review the entity's (1) plan to identify improper payments and (2) report on improper payments (or information about any findings), if any, that resulted from the entity's review under PIIA.

b. Evaluate whether preliminary analytical procedures identified any unusual or unexpected relationships that indicate fraud risks. To the extent that they are not already included, the analytical procedures, and evaluation thereof, should include procedures relating to revenue accounts—for example, trend analysis—to identify unusual or unexpected relationships that might indicate fraudulent financial reporting of revenue (see FAM 225 related to preliminary analytical procedures) (AU-C 240.22).

c. Consider whether other information—such as information that resulted from previous audits; the brainstorming meeting(s); and inherent risks identified at the account, transaction, or assertion levels—indicate fraud risks (AU-C 240.23 and 940.17).

Respond to Fraud Risks

.48 The auditor should respond to the risks of material misstatement due to fraud at the financial statement and assertion levels. The nature and significance of these fraud risks, as well as programs and controls that address fraud risks, influence the auditor's response. The auditor should use professional judgment in determining the appropriate response for the circumstances and exercise professional skepticism in gathering and evaluating audit evidence.

.49 If it is not practicable, as part of a financial statement audit, to design audit procedures that sufficiently respond to the fraud risks, the auditor may request assistance from the Special Investigator Unit and evaluate the effect of omitting these procedures on the scope of the audit and the audit report.

.50 In some instances, the audit strategy and audit plan could, for reasons other than responding to fraud risk, include procedures and personnel and supervisory assignments that are sufficient for responding to a fraud risk. In those instances, the auditor may conclude that no further response is required. For example, with respect to timing, audit procedures could be planned as of the date that the reporting period ends, both as a response to a fraud risk and for other reasons.

.51 The auditor should determine the overall responses to address the risks of material misstatement due to fraud **at the financial statement level** (AU-C 240.28). In doing so, the auditor should perform the following procedures:

a. Assign and supervise staff, taking into account the knowledge, skill, and ability of personnel to be given significant engagement responsibilities and the auditor's assessment of the risks of material misstatement due to fraud for the engagement (AU-C 240.29a). For example, the auditor may assign a fraud specialist or more experienced staff member or may increase supervision in response to identified fraud risks (also see FAM 270 related to IS controls auditors).

b. Evaluate whether the entity's selection and application of accounting policies, particularly those related to subjective measurements and complex transactions, may be indicative of fraudulent financial reporting resulting from management's effort to manage earnings or a bias that may create a material misstatement (AU-C 240.29b).

c. Incorporate an element of unpredictability in the selection of the nature, timing, and extent of audit procedures (AU-C 240.29c). For example, perform substantive procedures on selected account balances and assertions not otherwise tested due to their materiality or risk, adjust the timing of audit tests, use a different method to select items for testing, or perform procedures at different locations or at locations on an unannounced basis (AU-C 240.A42). Statistical sampling selection usually provides an element of unpredictability as to the specific items tested (see FAM 480). Generally, the auditor should not inform entity personnel of specific audit procedures prior to performing them, as personnel may take actions to further conceal any fraudulent activity. However, the auditor will usually make arrangements to conduct audit work at specific sites in advance, and will instruct entity personnel to locate certain documentation so that the auditor may test it upon arrival.

.52 Based on AU-C 240.30, the auditor should design and perform further audit procedures whose nature, timing, and extent are responsive to the risks of material misstatement due to fraud **at the assertion level** for which inherent risk is more than remote. Further audit procedures should involve both control and substantive tests. The auditor's response may include changing the nature, timing, and extent of further audit procedures (AU-C 240.A43), such as

a. obtaining evidence from independent external sources rather than internal sources (nature),

b. increasing sample sizes (extent), or

c. performing substantive procedures at or near the end of the reporting period rather than at an interim date (timing).

FAM 295 I provides additional examples of responses to fraud risks.

.53 Management is in a unique position to perpetrate fraud because of management's ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. Although the level of risk of management override of controls will vary from entity to entity, the risk is, nevertheless, present in all entities. Due to the unpredictable way in which such override could occur, it is a risk of material misstatement due to fraud and is thus a significant risk (AU-C 240.31).

.54 Even if the auditor did not identify specific risks of material misstatement due to fraud, a possibility exists that management override of controls could occur. Accordingly, the auditor should address the risk of **management override of controls** apart from any conclusions regarding the existence of more specifically identifiable risks by designing and performing the following procedures (AU-C 240.32):

a. **Examination of journal entries and other adjustments**—Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements, including

entries posted directly to financial statement drafts. These include reclassifications, consolidating entries, and other journal entries and adjustments. In designing and performing audit procedures for such tests, the auditor should

- obtain an understanding of the entity's financial reporting process and controls over journal entries and other adjustments, and evaluate the design and determine whether the controls have been implemented;
- inquire of individuals involved in the financial reporting process about inappropriate or unusual activity related to the processing of journal entries and other adjustments;
- consider fraud risk indicators, the nature and complexity of accounts, and unusual entries processed;
- select journal entries and other adjustments made at the end of the reporting period for testing; and
- consider the need to test journal entries and other adjustments throughout the period.

See AU-C 240.A47 through .A50 and .A56 for additional guidance.

b. **Review of accounting estimates**—Review accounting estimates for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud. In preparing financial statements, management is responsible for making judgments or assumptions that affect significant accounting estimates and for monitoring the reasonableness of these estimates on an ongoing basis.

In performing this review, the auditor should evaluate whether the judgments and decisions made by management in making accounting estimates included in the financial statements, even if they are individually reasonable, indicate a possible bias on the part of the entity's management that may represent a risk of material misstatement due to fraud. If so, the auditor should reevaluate the accounting estimates taken as a whole.

The auditor also should perform a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the prior year's financial statements. Estimates selected for review should include those that are based on highly sensitive assumptions or are otherwise significantly affected by judgments made by management. For example, significant changes in allowances for uncollectible accounts that may be tied to performance measures in an effort to improve collections.

c. **Evaluation of business purpose for significant unusual transactions**—Evaluate, given the auditor's understanding of the entity and its environment and other information obtained during the audit, whether the business purpose (or the lack thereof) of significant unusual transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets. The procedures should include the following:

- reading the underlying documentation and evaluating whether the terms and other information about the transaction are consistent with

explanations from inquiries and other audit evidence about the business purpose (or the lack thereof) of the transaction;

- determining whether the transaction has been authorized and approved in accordance with the entity's established policies and procedures; and
- evaluating whether significant unusual transactions that the auditor has identified have been properly accounted for and disclosed in the financial statements.

Fraud risk indicators include the following (AU-C 240.A54):

- the form of these transactions appears overly complex (for example, the transactions involve multiple entities within a consolidated group or multiple unrelated third parties);
- management has not discussed the nature of and accounting for these transactions with those charged with governance, and inadequate documentation exists;
- management is placing more emphasis on the need for a particular accounting treatment than on the economic substance of the transaction;
- transactions involve disclosure entities, related parties, or public-private partnerships, including special purpose entities, have not been properly reviewed or approved by those charged with governance;
- transactions involve disclosure entities, related parties, or public-private partnerships or relationships or transactions with such entities previously undisclosed to the auditor (see FAM 904);
- transactions involve other parties that do not have the substance or financial strength to support the transactions without assistance from the entity or any disclosure entity, related party, or public-private partnership of the entity; and
- transactions occur with a party that falls outside the definitions of a related party, disclosure entity, or public-private partnership (as defined by the applicable financial reporting framework (generally U.S. GAAP)), with either party able to negotiate terms that may not be available for other, more clearly independent parties on an arm's–length basis.

The auditor should determine whether other audit procedures, in addition to those discussed above, are needed to address the risks of management override of controls (AU-C 240.33).

.55 If the auditor identifies deficiencies in controls designed to prevent, or detect and correct, misstatements caused by fraud, the auditor should take into account those deficiencies when developing the response to risks of material misstatement (AU-C 940.17).

Evaluate Audit Evidence Obtained

.56 The auditor should evaluate whether the audit evidence obtained from the risk assessment procedures provides an appropriate basis for the identification and assessment of the risks of material misstatement. If not, the auditor should perform additional risk assessment procedures until audit evidence has been obtained to provide an appropriate basis. In identifying and assessing the risks of

material misstatement, the auditor should take into account all audit evidence obtained from the risk assessment procedures, whether corroborative or contradictory to assertions made by management (AU-C 315.39).

.57 If the auditor obtains new information that is inconsistent with the audit evidence on which the auditor originally based the identification or assessments of the risks of material misstatement, the auditor should revise the identification or assessment (AU-C 315.41). See FAM 530 for guidance on reassessing the risks of material misstatement.

270 – Determine Likelihood of Effective IS Controls

.01 As discussed in FAM 265, information systems often involve **information system processing**, which is performed through the use of information technology. When relevant control activities,[38] discussed in FAM 350, depend on information system processing, the auditor should assess IS controls. A dependency on information system processing exists if a control activity cannot reasonably be expected to achieve a specific control objective without effective information system processing, either in the performance of the control activity or in the production of information used in the performance of the control activity.

.02 IS controls consist of those internal controls that depend on information system processing and include general controls, application controls, and user controls. Information system general controls (implemented at the entity-wide, system, and application levels) are the structure, policies, and procedures that apply to all or a large segment of an entity's information systems.

.03 **General controls** help ensure the proper operation of information systems by creating the environment for effective operation of application controls. General controls include security management, access (logical and physical), configuration management, segregation of duties, and contingency planning controls. An effective information system general control environment

- provides a framework and continuing cycle of activity for managing risk, developing security policies, assigning responsibilities, and monitoring the adequacy of the entity's computer-related controls (security management);
- limits or detects access to computer resources, such as data, programs, equipment, and facilities, thereby protecting them against unauthorized modification, loss, or disclosure (logical and physical access);
- prevents unauthorized changes to information system resources, such as software programs and hardware configurations, and provides reasonable assurance that systems are configured and operating securely and as intended (configuration management);
- includes policies, procedures, and an organizational structure to manage who can control key aspects of computer-related operations (segregation of duties); and
- protects critical and sensitive data, and provides for critical operations to continue without disruption or be promptly resumed when unexpected events occur (contingency planning).

.04 **Application controls**, sometimes referred to as business process controls, are those controls incorporated directly into information systems to help ensure the validity, completeness, accuracy, and confidentiality of transactions and data during information system processing. An effective application control environment includes

[38]"Relevant controls" or "relevant control activities" as used in the FAM are referred to as identified controls or controls that address the risks of material misstatement at the assertion level in AU-C 315.

- general controls implemented at the application level (i.e., security management, access controls, configuration management, segregation of duties, and contingency planning);
- controls over transaction data input, processing, and output as well as master data maintenance;
- interface controls over the timely, accurate, and complete processing of information between information systems; and
- controls over the data management systems.

.05 **User controls** are portions of controls that people perform when interacting with information systems. The effectiveness of a user control typically depends on information system processing or the reliability of the information that information systems produce. A user control is considered both an IS control and a manual control if it depends on information system processing. For example, the effectiveness of a user control to review and follow up on exceptions typically depends on the reliability of the exception report that the information system produces through information system processing. A user control is considered a manual control if it does not depend on information system processing. For example, the effectiveness of a user control to manually reconcile information that information systems produce may or may not depend on the reliability of information used in the reconciliation, depending on the nature of the control. Additionally, the effectiveness of a user control to monitor the effective functioning of information systems and IS controls may or may not depend on the reliability of information that the information systems produce.

.06 In the planning phase, the auditor should identify and document the relevant control activities that depend on information system processing. Such control activities are often application and user controls. The auditor should then identify and document the general controls implemented at the entity-wide, system, and application levels that help ensure the effective operation of the application and user controls. Because of the technical nature of many IS controls, the auditor generally should obtain assistance from an IS controls auditor in planning, directing, or performing audit procedures related to assessing IS controls. Additionally, an information technology specialist may assist the auditor in understanding technical aspects of information systems and IS controls.[39]

.07 The auditor should understand the design of the general controls identified to the extent necessary to conclude tentatively whether these controls are likely to be effective. The procedures performed to determine the likelihood of effective IS controls build on those procedures performed to (1) gain an understanding of the entity's operations, including the design of its internal controls, and (2) assess the effects of information technology and information system processing on inherent risk and internal control.

.08 If the general controls identified are likely to be effective, the auditor should consider other specific IS controls in determining whether control objectives are

[39]An information technology specialist differs from an IS controls auditor. An information technology specialist possesses special skills or knowledge in the information technology field that extend beyond the skills and knowledge normally possessed by those working in specialized fields of auditing, such as IS controls auditing. Auditors and IS controls auditors may decide to seek the assistance of an information technology specialist to complete various aspects of the engagement.

achieved in the internal control phase. As discussed in AU-C 315.A201, evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements. See FAM 350.

.09 If the general controls identified are not likely to be effective, the auditor should obtain a sufficient understanding of information system processing to

- identify types of potential misstatements,
- consider factors that affect the risks of material misstatement,
- design tests of controls and substantive procedures, and
- develop appropriate findings.

.10 Also, in the internal control phase, the auditor generally should understand the design effectiveness of manual controls in achieving control objectives, including manual reviews or reconciliations, that may mitigate deficiencies in IS controls. If IS controls are not likely to be effective because of poor general controls **and** if manual controls do not achieve the control objectives, the auditor should understand the design of any application-level IS controls that are intended to achieve the control objectives to develop recommendations for improving internal controls.

.11 The auditor should use an appropriate methodology when identifying and assessing IS controls and should document the basis for believing that the methodology used is appropriate to satisfy these requirements. If the auditor uses the same methodology for multiple audits, the audit organization may prepare this document once and maintain a central file for reference on individual audits.

GAO auditors should use the *Federal Information System Controls Audit Manual* (FISCAM) when assessing IS controls in a financial statement audit. FISCAM is designed to meet these requirements, and GAO believes that FISCAM is an appropriate methodology. See FAM 295 J for a flowchart of steps generally followed in assessing IS controls in a financial statement audit.

.12 Information system security controls are also addressed in

- OMB Circular No. A-130, *Managing Information as a Strategic Resource*;
- NIST's *An Introduction to Information Security*; and
- National Security Agency guidance on Microsoft and other computer vendor websites and various publications.

OMB's guidance on reporting under FISMA specifies NIST publications that agencies are to use when evaluating information security (see FISMA section in FAM 260). The auditor may coordinate the work performed to meet the provisions of FISMA (44 U.S.C. §§ 3551-3558) with work performed as part of the financial statement audit.

275 – Identify Relevant Operations Controls to Evaluate and Test

.01 In a financial statement audit, the auditor draws a conclusion about the effectiveness of financial reporting (including safeguarding and budget) and compliance (including budget) controls. For operations controls, the auditor

- may evaluate certain operations controls considered relevant (see FAM 275.02 through .07) and
- should evaluate and test operations controls that are relied on in performing audit procedures (see FAM 275.08).

Relevant Operations Controls

.02 Relevant operations controls are based on the needs of the auditor. The auditor should determine whether the evaluation of relevant operations controls will (1) be included in the financial audit, (2) become a separate audit, or (3) not be performed though any deficiencies noted will be reported to entity management and the IG. In making this determination, the auditor may consider the following factors:

- the significance of the operations controls to the entity's operations,
- the time required to identify and test the operations controls,
- available resources,
- the needs of those charged with governance, and
- congressional interest.

.03 The auditor should document the operations controls identified for testing, the procedures performed, and the results.

.04 In the planning phase and throughout the audit, the auditor may identify significant areas where the entity would be expected to have operations controls. The auditor may become aware of these areas, as well as potential deficiencies in operations controls, through

- prior audit work;
- documenting an understanding of entity operations;
- assessing the risks of material misstatement and deficiencies in financial reporting and compliance controls;
- other audit planning procedures, including any reviews of the FMFIA documentation that the entity prepared;
- understanding the cause of misstatements noted; or
- observing activities during fieldwork.

.05 In obtaining an understanding of the entity's operations, the auditor typically would have identified areas that are critical to the operations. For each of these areas, the entity should have effective operations controls. Also, in planning the audit, the auditor may identify operations controls that could be evaluated in

conjunction with planned audit and other procedures. For example, in a test of inventory purchases the auditor may evaluate whether management considered appropriate order quantities for each inventory purchase selected to avoid a buildup of excess inventory.

.06 The auditor may identify risks of material misstatement and control deficiencies in planning and performing the audit and in determining the causes of misstatements requiring audit adjustments. The auditor should evaluate the implications of those risks and deficiencies on the entity's operations controls if

- the effectiveness of a financial reporting or compliance control depends on the effectiveness of the operations control;
- the auditor plans to rely on this control during the audit; or
- the auditor is required to test the control following OMB audit guidance.

For example, misstatements in inventory records may indicate deficiencies in operations controls whose effectiveness depends on accurate inventory records. This would include the operations controls for maintaining proper inventory levels, including those for detecting theft or loss.

.07 The auditor may find opportunities to recommend improvements to operations controls and may choose to test the effectiveness of other operations controls. Such opportunities could come to light while visiting the entity's various locations and performing audit procedures.

Operations Controls Relied on in the Audit

.08 If any contemplated audit procedure relies on operations controls, the auditor should identify and test such controls. For example, assume that an auditor is using substantive analytical procedures, based on entity-generated "per unit" statistics, to test the reasonableness of certain operating costs. The auditor plans to compare such per unit statistics with published costs incurred by similar operations. The auditor should identify and test the entity's operations controls and other types of controls, as appropriate, over the production of these internal statistics.

As discussed in FAM 495 A.20 through .22, if the reliability of internally generated data used in substantive tests, such as substantive analytical procedures, depends on the effectiveness of IS controls, the auditor should perform additional procedures before relying on the data. The auditor should test, as appropriate, the relevant general controls and the specific application level controls over the data, the data in the report, or both.

280 – Plan Other Audit Procedures

.01 The auditor generally should plan for performing procedures in the following areas during other phases of the audit.

The auditor should also consider the implementation guidance in volume 2 of the FAM as applicable. Volume 2 includes areas such as using the work of others, determining compliance with FFMIA and other laws, performing agreed-upon procedures, and substantive testing.

Litigation, Claims, and Assessments

.02 The auditor should make inquiries of the entity's legal counsel and perform other audit procedures regarding litigation, claims, and assessments. This is necessary to assess potential liabilities and contingencies. Entity management and legal counsel may need significant time to gather and report necessary information, including the potential need for inquiries of Department of Justice legal counsel on a case-specific basis. Additionally, for initial audits and changes in personnel, the auditor may discuss with management why a response from the entity's legal counsel is needed as part of a financial statement audit. See FAM 1002 for additional guidance.

.03 Based on AU-C 501.17 and .A43, the auditor should design and perform audit procedures to identify litigation, claims, and assessments involving the entity that may give rise to a risk of material misstatement, including

- inquiring of management and, when applicable, others within the entity, including in-house legal counsel, which may include discussing their policies and procedures for identifying, evaluating, and accounting for litigation, claims, and assessments;
- obtaining from management a description and evaluation of litigation, claims, and assessments that existed at the date of the financial statements being reported on and during the period from the date of the financial statements to the date the information is furnished, including identification of those matters referred to legal counsel;
- reviewing minutes of meetings of those charged with governance; documents obtained from management concerning litigation, claims, and assessments; and correspondence between the entity and its legal counsel; and
- reviewing legal expense accounts and invoices from external legal counsel.

.04 Based on AU-C 501.19 and .20, the auditor should seek direct communication with the entity's in-house legal counsel regarding the entity's litigation, claims, and assessments.[40] The auditor should do so through a legal counsel request prepared by management and sent by the auditor requesting that the entity's in-house legal counsel communicate directly with the auditor.

In addition to the direct communication with the entity's in-house legal counsel, the auditor should, when the entity's external legal counsel is responsible for the

[40]In the federal government, in-house legal counsel generally has primary responsibility for the entity's legal matters and thus is most knowledgeable about the entity's litigation, claims, and assessments.

entity's litigation, claims, and assessments, seek direct communication with the entity's external legal counsel through a legal counsel request similar to the request made to the in-house legal counsel.[41]

The legal counsel response(s) may be limited to matters that are considered individually or collectively material to the financial statements, such as when the entity and the auditor have reached an understanding on the limits of materiality for this purpose and management has communicated such understanding to the legal counsel (AU-C 501.A57). See FAM 1002 B for an example legal counsel request and FAM 1002 C for an example legal counsel response.

.05 During planning, the auditor also should apply any additional requirements in OMB audit guidance related to legal counsel requests and responses. For example, OMB audit guidance indicates that the interim and updated responses from legal counsel for specified entities are to be submitted to specified parties by specific dates that the Department of the Treasury establishes.

Management Representations

.06 As discussed in FAM 550, the auditor should obtain a representation letter from entity management, and when appropriate, those charged with governance, on specific matters at the completion of the audit. Particularly for first-year audits, when standards change, and when management changes, the auditor may find it useful to discuss representations with management early in the audit to identify and resolve any difficulties related to obtaining these representations at the end of the audit. These representations include

- the effectiveness of internal control over financial reporting;
- compliance with laws, regulations, contracts, and grant agreements;
- management's materiality thresholds for reporting; and
- for CFO Act agencies, whether financial management systems comply substantially with FFMIA requirements.

Additionally, the auditor should prepare a summary of uncorrected misstatements (including prior period misstatements that affect the current financial statements) and attach it to the representation letter. FAM 595 C provides an example of a summary of uncorrected misstatements. The representation letter should state management's belief that the effects of the misstatements are immaterial to the financial statements as a whole, both individually and in the aggregate.

During planning, the auditor should also apply any additional requirements in OMB audit guidance related to management representations. For example, OMB audit guidance indicates that the auditor should provide and discuss with management a draft representation letter as early as possible in the audit and update the letter for circumstances found throughout the audit. Additional guidance on management representations is provided in AU-C 580, AU-C 940, AT-C 205, AT-C 215, AT-C 315, and FAM 1001.

[41] In the federal government, the main legal counsel outside of the entity is the Department of Justice.

Relationships and Transactions with Disclosure Entities, Related Parties, and Public-Private Partnerships

.07 Throughout the planning phase, the auditor should perform procedures to (1) obtain an understanding of the entity's relationships and transactions with disclosure entities, related parties, and public-private partnerships (see FAM 220); (2) consider the susceptibility of the financial statements to material misstatement due to fraud or error that could result from such relationships and transactions (see FAM 265); and (3) identify the risks of material misstatement (see FAM 265).[42] The identity of the entity's disclosure entities, related parties, and public-private partnerships and other relevant information should be distributed to all members of the engagement team (AU-C 550.19).

Throughout the audit, engagement team members should remain alert when inspecting records or documents for arrangements or other information that may indicate the existence of additional relationships or transactions with disclosure entities, related parties, and public-private partnerships that management has not previously identified or disclosed to the auditor (AU-C 550.17). Also see FAM 904 for additional procedures the auditor should perform and FAM 550 for concluding on relationships and transactions with disclosure entities, related parties, and public-private partnerships.

The auditor generally should (1) inquire about the population of entities that management considered when evaluating the existence of a disclosure entity and the method used to assess whether an entity meets the requirements for disclosure and (2) for any disclosure entities identified by management, inquire of the methods for determining the information that should be disclosed in the financial statements, which is based on both qualitative and quantitative materiality and the following factors (SFFAS 47):

- relevance to reporting objectives;
- nature and magnitude of the potential risks/exposures or benefits associated with the relationship;
- complexity of the relationship;
- extent to which the information interests, or may be expected to interest, a wide audience; and
- extent to which there are no alternative sources of reliable information.

Required Supplementary Information

.08 Per U.S. GAAP, certain information is to be included with the entity's financial statements and to be labeled as RSI. Although this information is not a part of the financial statements, FASAB considers this information to be an essential part of financial reporting for placing the financial statements in appropriate operational, economic, or historical context (AU-C 730.04). Some examples of RSI include

[42]Procedures related to disclosure entities and public-private partnerships do not apply to entities issuing financial statements in accordance with FASB accounting standards.

the MD&A, information regarding social insurance per SFFAS 17, and information regarding the Statement of Custodial Activity per SFFAS 7.

For RSI, the auditor should perform the following (AU-C 730.05):

a. Inquire of management about the methods of preparing the information, including
   - whether it has been measured and presented in accordance with the prescribed guidelines,
   - whether methods of measurement or presentation have been changed from those used in the prior period and the reasons for any such changes, and
   - whether there were any significant assumptions or interpretations underlying the measurement or presentation of the information.

b. Compare the information for consistency with (also see FAM 520 for applying analytical procedures)
   - management's responses to the auditor's inquiries,
   - the financial statements, and
   - other knowledge obtained during the audit of the basic financial statements.

c. Obtain written representations from management
   - that it acknowledges its responsibility for RSI;
   - about whether RSI is measured and presented in accordance with prescribed guidelines;
   - about whether the methods of measurement or presentation have changed from those used in the prior period and, if so, the reasons for such changes; and
   - about any significant assumptions or interpretations underlying the measurement or presentation of RSI—refer to FAM 1001 A for management representation letter example.

OMB also provides reporting guidance on RSI. See FAM 550.23 through .24 for information on concluding on RSI and FAM 580.38 regarding how the auditor reports on the work performed in this area.

Other Information Included with the Financial Statements

.09 Per U.S. GAAP and OMB reporting guidance, certain information is to be included with the entity's financial statements and to be labeled as other information. Other information is financial or nonfinancial information (other than the basic financial statements, RSI, and auditor's report) included in an entity's annual report (AU-C 720.12).

For other information, the auditor should perform the following:

a. Through discussion with management, determine and obtain management's written acknowledgment regarding which document(s) comprise the annual

report and the entity's planned manner and timing of the issuance of such document(s) (AU-C 720.13a).

b. Make appropriate arrangements with management to obtain in a timely manner and, if possible, prior to the date of the auditor's report, the final version of the document(s) comprising the annual report (AU-C 720.13b).

c. When some or all of the documents determined to be part of the annual report will not be available until after the date of the auditor's report on the financial statements, request management to provide a written representation that the final version of the documents will be provided to the auditor when available, and prior to the documents' issuance by the entity, such that the auditor can complete the required procedures (AU-C 720.13c).

d. If the auditor becomes aware that the entity did not provide the auditor with the final version of documents determined to be part of the annual report prior to the issuance of those documents to third parties, the auditor should take appropriate action (AU-C 720.14), which may include

- obtaining those documents from management and performing the required procedures, as discussed below, as soon as practical;
- communicating the matter to those charged with governance, if applicable; and
- considering the need to obtain legal advice (AU-C 720.A25).

e. Communicate with those charged with governance the auditor's responsibility with respect to the other information, any procedures performed relating to the other information, and the results (AU-C 720.15).

f. Read the other information and consider whether a material inconsistency exists between the other information and the financial statements. As the basis for this consideration, to evaluate their consistency, the auditor should compare selected amounts or other items in the other information (that are intended to be the same as, to summarize, or to provide greater detail about the amounts or other items in the financial statements) with such amounts or other items in the financial statements. While reading the other information, the auditor should remain alert for indications that (1) a material inconsistency exists between the other information and the auditor's knowledge obtained in the audit and (2) a material misstatement of fact exists or the other information is otherwise misleading. The auditor is not responsible for searching for omitted information for the completeness of the other information. (AU-C 720.16–.18)

See FAM 550.25 through .29 for information on concluding on other information and FAM 580.39 regarding how the auditor reports on the work performed in this area.

Supplementary Information

.10 If the auditor is engaged to report on whether supplementary information, such as consolidating statements, is fairly stated, in all material respects, in relation to the financial statements as a whole, the auditor should follow the requirements in AU-C 725, *Supplementary Information in Relation to the Financial Statements as a Whole*.

Opening Balances

.11 AU-C 510, *Opening Balances—Initial Audit Engagements, Including Reaudit Engagements*, provides guidance on the audit procedures the auditor should perform related to opening balances in an engagement in which the financial statements for the prior period were not audited or were audited by a predecessor auditor (initial audit engagement). This includes engagements to audit financial statements that have been previously audited by a predecessor auditor (reaudit engagement).

During the planning phase, the auditor should request that entity management authorize the predecessor auditor, if any, to allow a review of its audit documentation and respond fully to inquiries by the auditor. The auditor uses this information to assist in planning and performing the audit. The auditor should plan audit procedures to obtain sufficient appropriate audit evidence about whether

a. opening balances, including note disclosures that existed at the beginning of the period, contain misstatements that materially affect the current year's financial statements and

b. appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements or changes thereto are appropriately accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework (generally U.S. GAAP).

See AU-C 510 for the specific requirements to be satisfied related to performing, concluding on, and reporting on opening balances for initial audit engagements and reaudit engagements.

Other Planning Issues

.12 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 of material misstatement and determining the nature, timing, and extent of further audit procedures, including determining the extent to which testing the implementation of the corrective actions is applicable to the current audit objectives.

.13 The auditor should determine whether any findings and recommendations from the prior-year financial audit need follow-up that would not otherwise be evaluated in the current-year procedures, such as findings at locations that would not otherwise be tested. The auditor should determine whether to test the implementation of the recommendation or to repeat the finding.

Additional Audit Guidance

.14 During planning, the auditor also should apply additional requirements in OMB audit guidance. For example, OMB audit guidance indicates that certain agreed-

upon procedures are to be applied to entity payroll offices and the related reports are to be submitted to the Office of Personnel Management by a specific date. FAM 710 provides guidance on agreed-upon procedures reporting.

285 – Plan Locations to Test

.01 Most entities conduct operations, perform accounting functions, and retain records at multiple locations. During planning, the auditor should evaluate the effect of these multiple locations on the audit approach and generally should consult with an audit sampling specialist when testing involves the selection of locations. The auditor should develop an understanding of the respective locations, including the material classes of transactions processed and significant financial management systems used at those locations. This understanding may be obtained virtually, in person, or both and either centrally or in combination from multiple field locations, as appropriate. When planning locations to test, the auditor should evaluate whether certain locations warrant more extensive testing than others, based on the following factors:

a. **Materiality or significance of locations to the overall entity.** More material locations, particularly those individually generating transactions or account balances that exceed performance materiality or those with significant information system processing may indicate the need for more extensive testing.

b. **The results, if location specific, of the preliminary analytical procedures applied during planning.** The auditor should follow up on unusual results, possibly including testing specific locations with unusual results.

c. **The results and the extent of audit procedures applied in prior years by the auditor or others, including the time since significant procedures were performed.** Problems noted in prior audits, if not corrected, could indicate areas of concern for the current audit; the applicability of prior evidence ordinarily diminishes with the passage of time.

d. **The auditor's understanding of internal control components, and preliminary assessment of overall inherent risk, at each location, including the nature of operations, sensitivity to economic conditions, and key management turnover.** Locations at which internal control components are weak or inherent risk is high generally warrant more extensive testing than those where internal control components are strong or inherent risk is low. In addition, the inherent risk may be different for different accounts and assertions at each location.

e. **The auditor's assessment of the risk of material misstatement due to fraud.** Locations at which the auditor has assessed a higher risk of material misstatement due to fraud warrant more extensive testing than those where the auditor has assessed a lower risk of material misstatement due to fraud.

f. **The auditor's assessment of the risk of material misstatement.** Locations at which risk of material misstatement is high warrant more extensive testing than locations where risk of material misstatement is low.

g. **The extent to which accounting records are centralized.** A high degree of centralization may enable the auditor to conduct the majority of work on the central location, with only limited work on other locations.

h. **The extent of uniformity of control systems (including IS controls) throughout the entity.** The number of locations tested is a function of the uniformity of significant control systems. For example, if there are two major

procurement control systems, the auditor generally should test each system to a sufficient extent. Where locations develop or modify systems, the auditor may test more locations than for those entities using centrally developed systems that cannot be changed locally.

i. **The extent of work performed by other auditors.** The auditor may use work performed by other auditors to reduce or eliminate testing selected locations or to assist in testing locations not selected. (See FAM 620, 630, 640, and 645.)

j. **Special reporting or entity requirements.** The auditor should test sufficient locations to meet special needs, such as the need for separate-location reports.

.02 The auditor should plan the general nature of audit procedures to be performed for each location. The extent of testing may vary between locations, depending on tolerable misstatement, risk of material misstatement, and other factors. Using common audit plans, audit documentation formats, and indexes for the various locations tested makes it easier to plan, review the audit documentation, and combine the results of all locations to improve effectiveness and efficiency. The auditor should vary the nature, timing, and extent of testing controls at locations or business units from year to year.

.03 The auditor should obtain an understanding of the design of the procedures for combining the locations' financial information to prepare the entity's financial statements. The auditor should understand and test these procedures during the audit, including controls for adjustments, reclassifications, and eliminations.

.04 One approach to stratifying locations, selecting locations to test, and selecting individual audit samples for multiple-location audits is presented in FAM 295 C. This method assumes that increased testing is not required for any location because of the factors in FAM 285.01. If the auditor uses other methods to select locations for testing, the basis for doing so must be provided to the reviewer in a timely manner to allow any issues to be promptly identified and resolved. For example, selecting fewer locations but more items to test for each location may be appropriate in some instances. Although other methods generally involve more testing than the method described in FAM 295 C, the efficiencies of performing additional work on fewer locations may be higher.

.05 The auditor should document the planned locations to test in the audit strategy, audit plans, or equivalent documents.

290 – Documentation

.01 Based on AU-C 230.08, the auditor should prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand

- the nature, timing, and extent of the audit procedures performed to comply with GAGAS, including the AICPA Statements on Auditing Standards and applicable attestation standards, and applicable legal and regulatory requirements;
- the results of the audit procedures performed and the audit evidence obtained; and
- significant findings or issues arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions.

AU-C 230.A4 describes factors that the auditor should consider in determining the form, content, and extent of audit documentation.

.02 In the FAM, each phase of the audit contains a separate section that describes audit documentation requirements. The auditor should document relevant information as described in this section and update these documents to respond to any changes in circumstances during the course of the audit. The auditor should document any significant changes made during the audit engagement to the overall audit strategy or the audit plan and the reasons for such changes (AU-C 300.14c). Information that is likely to be useful in future audits may be documented in a permanent file.

.03 The auditor should document the understanding of the **terms of the engagement** established with the client, including the understandings reached with management and those charged with governance as described in FAM 215. This documentation may consist of copies of engagement letters, contracts, and other written agreements and should document management's agreement with its responsibilities in a financial statement audit.

.04 In the **entity profile** or an equivalent document, the auditor should document the information useful for understanding the entity and its operations (FAM 220). Based on AU-C 315.19 and .42b, the auditor should document key elements of the auditor's understanding, including those discussed in FAM 220.01, and the sources of information from which the auditor's understanding was obtained.

The auditor generally should limit the information in the entity profile to that which is relevant to planning the audit. This information may include documents prepared by the entity, such as historical information or the mission of the entity. If these and other documents were prepared in prior years, the auditor should update them for any changes each year.

.05 The auditor should document the results of **brainstorming discussions** about the susceptibility of the entity's financial statements to material misstatement due to error or fraud (FAM 265). The auditor should document these discussions, including how and when the discussion occurred, the subject matter discussed, the engagement team members who participated, and significant decisions reached (AU-C 240.43a and 315.42a).

.06 In establishing the overall **audit strategy** that sets the scope, timing, and direction of the audit and that guides the development of the audit plan, as discussed in AU-C 300.07 through .08, the auditor should

a. identify the characteristics of the engagement that define its scope;

b. ascertain the reporting objectives of the engagement in order to plan the timing of the audit and the nature of the communications required;

c. consider the factors that in the auditor's professional judgment, are significant in directing the engagement team's efforts;

d. consider the results of preliminary engagement activities and, when applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and

e. ascertain the nature, timing, and extent of resources necessary to perform the engagement.

.07 The audit strategy should include or refer to information on the following areas:

a. **Conclusions reached regarding acceptance and continuance of the client relationship and audit engagement, including inquiries of the predecessor auditor and the results thereof, if applicable (FAM 215).**

b. **Parties identified as those charged with governance (FAM 215).**

c. **Compliance with relevant ethical requirements (FAM 215).** This information includes

- any issues identified and how they were resolved,
- any threats to independence and the safeguards applied, and
- conclusions on compliance with independence requirements that apply to the audit engagement and any relevant discussions with the audit organization that support the conclusion.

d. **Accounting and auditing standards (FAM 215).**

- Accounting standards, including whether the financial reporting framework to be applied in the preparation of the financial statements (generally U.S. GAAP) is acceptable.
- Auditing standards and guidance applicable to the engagement (e.g., GAGAS), including any
  - interpretive publications, which consist of, among other things, auditing interpretations of U.S. GAAS, auditing guidance included in AICPA Audit and Accounting Guides, and AICPA Auditing Statements of Position (AU-C 200.14 and .27), and
  - other auditing publications (AU-C 200.28).

e. **Results of the prior year's audit.**

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

- Data used and the sources of these data for current-year amounts and for developing expected amounts, including

- the amounts of the financial items;
- the dates or periods covered by the data;
- whether the data are audited or unaudited;
- the person from whom the data were obtained (if applicable); and
- the source of the information, such as general ledger trial balances, prior-year audit documentation, or prior-year financial statements.

- Parameters for identifying significant fluctuations from expectations.
- Explanations for fluctuations from expectations identified and sources of those explanations, including the name(s) and title(s) of the person(s) from whom the explanations were obtained.
- The auditor's conclusion and consideration of the impact of the results of preliminary analytical procedures on the audit strategy.

g. **Amount and basis for materiality determination and any revisions to materiality as the audit progresses (FAM 230).** This should include

- materiality for the financial statements as a whole,
- performance materiality,
- tolerable misstatement,
- clearly trivial,
- materiality levels for FMFIA, management representation letter, and legal counsel response, and
- if applicable, materiality levels for particular line items, accounts, note disclosures, or classes of transactions (AU-C 320.14).

h. **Significant provisions of applicable laws and regulations (FAM 245).**

i. **Approach for identifying and testing significant provisions of contracts and grant agreements (FAM 245).**

j. **Relevant budget restrictions (FAM 250).**

k. **Understanding of the design and implementation of each component of internal control (FAM 260).** Based on AU-C 315.42b, the auditor should document

- key elements of the understanding of each of the five internal control components, including the effect of information technology on internal control, and any identified control deficiencies;
- risk assessment procedures performed to obtain this understanding;
- sources of information from which this understanding was obtained; and
- conclusions reached on whether each component was implemented as designed.

The design and implementation of specific control activities is discussed in FAM 340 and 350, and the related documentation requirements are discussed in FAM 390. For CFO Act agencies, the auditor generally should

also document the entity's basis for its determination of substantial compliance of its financial management systems with FFMIA requirements.

l. **Audit assurance (FAM 265).** The auditor should document the audit assurance used and the auditor's justification for it. If the audit assurance used is 95 percent, the auditor may reference the FAM.

m. **Risks of material misstatement at the financial statement level (FAM 265).** Based on AU-C 315.42d, the auditor should document the following, including the rationale for significant judgments made, if not otherwise apparent.

- Risks of material misstatement due to error or fraud identified at the financial statement level (those that relate pervasively to the financial statements as a whole).
- The auditor's assessment of such risks (i.e., the auditor's evaluation of the nature and extent of their pervasive effect on the financial statements and whether they affect the assessment of risks at the assertion level; see FAM 265.19).
- The auditor's overall responses to such risks (see AU-C 330.A1–.A2).

n. **Risks of material misstatement at the assertion level (FAM 265).** Based on AU-C 315.42d, the auditor should document the following, including the rationale for significant judgments made, if not otherwise apparent. The auditor may document this information in the audit strategy or refer to the LIRA form or equivalent where the information is documented (see FAM 290.09).

- Identified risks of material misstatement due to error or fraud at the assertion level for material line items, accounts, note disclosures, and classes of transactions.
- For each identified risk of material misstatement, the auditor's assessment of inherent risk at one of four levels (i.e., remote, low, moderate, or high) and the basis for that assessment, including how inherent risk factors affect the susceptibility of assertions to misstatement and the degree to which they do so, in the preparation of the financial statements in accordance with the applicable financial reporting framework (generally U.S. GAAP) (AU-C 315.19c and .42b).
- For each identified risk of material misstatement assessed at **low, moderate, or high**,
  - whether the risk is a significant risk (see below) and
  - the planned nature, extent, and timing of substantive procedures to address the risk and references to related audit plan steps (see FAM 400).

o. **Significant risks (FAM 265).** The auditor should document the significant risks identified. For risks of material misstatement due to **fraud** (fraud risks) that are significant risks (i.e., inherent risk is more than remote), the auditor should also document

- the type of fraud risks identified (fraudulent financial reporting or misappropriation of assets);

- if the auditor did not identify any fraud risks relating to revenue recognition, the reasons supporting that conclusion;
- the procedures performed to assess fraud risks, such as interviews with entity personnel regarding fraud and the brainstorming discussions noted in FAM 290.05;
- consideration of the risk of management override of controls and other matters, such as significant abuse; and
- the effect of fraud risks on the audit strategy.

p. **Likelihood of effective IS controls and methodology used to assess them (FAM 270).** The auditor should document

- a basic understanding of the design and implementation of IS controls and tentative conclusions on the likelihood that they are effective (the auditor documents specific IS controls in the SCE worksheet at FAM 395 G or equivalent) and
- the methodology used for assessing IS controls and the basis for believing that it is appropriate.

As discussed in FAM 270, GAO auditors should use FISCAM as GAO believes that it is an appropriate methodology. If the auditor uses the same methodology for multiple audits, the audit organization may prepare this document once and maintain a central reference file for individual audits.

When the auditor prepares documentation of the above information, the auditor generally should obtain concurrence from an IS controls auditor. The director and assistant director, as part of their reviews of the audit strategy, should concur with the tentative conclusions on the likelihood that IS controls are effective. If the auditor determines that IS controls are not likely to be effective, the auditor should document supporting evidence and generally should report these findings as discussed in FAM 580. Due to the sensitive nature of security issues related to information systems, the auditor may include the details of these issues in a nonpublic report.

q. **Operations controls to be tested, if any (FAM 275).**

r. **Other planned audit procedures (FAM 280).**

s. **Locations to test (FAM 285).** This information includes

- the locations selected;
- the basis for selections;
- the nature and timing of procedures planned for each location;
- the determination of the number of items for testing and the allocation of those items among the selected locations (this may be initially discussed and estimated and later refined when the items are selected, particularly for a statistical sample); and
- other procedures applied.

t. **Planned interim testing (FAM 295 D).** This information includes the basis for concluding that the use of interim testing is appropriate.

u. **Staffing and review requirements.** This information includes

- engagement team members and specialists, who, collectively, have the appropriate competence and capabilities to perform the audit in accordance with GAGAS and enable an auditor's report that is appropriate in the circumstances (GAGAS (2018) 4.02 and AU-C 220A.16) and
- the nature, timing, and extent of direction and supervision of engagement team members and review of their work (AU-C 300.11).

v. **Audit timing, including milestones and the estimated date of the auditor's report.**

w. **Extent of assistance from entity personnel.**

.08 The **cycle matrix** or equivalent links material line items, accounts, note disclosures, and classes of transactions to the related significant financial management systems, LIRA forms, and cycles, as applicable (see FAM 235).

.09 The **LIRA** form or equivalent contains, for each material line item, account, note disclosure, and class of transactions, the auditor's identification and assessment of risks of material misstatement at the assertion level. The LIRA form should include all of the items listed in FAM 290.07n. If appropriate, the auditor may use one LIRA form for a material line item and all of the material accounts, note disclosures, and classes of transactions related to it. See FAM 395 H for specific instructions on preparing the LIRA form.

.10 The auditor should develop an **audit plan** that includes a description of the following items:

- The nature and extent of planned risk assessment procedures sufficient to identify and assess the risks of material misstatement, as discussed in FAM 265 (AU-C 300.09a).
- The nature, extent, and timing of planned further audit procedures at the assertion level for each material line item, account, note disclosure, and class of transactions, as discussed in FAM 350 and 420 (AU-C 300.09b). The plan for further audit procedures should include (1) tests of operating effectiveness of relevant control activities identified in the SCE worksheet and (2) the nature, extent, and timing of planned substantive procedures included in the LIRA form.[43]
- Other planned audit procedures to be carried out for the engagement to comply with GAGAS (AU-C 300.09c). See the audit completion checklist in FAM 1003, which assists the auditor with determining whether the auditor has complied with GAGAS and followed the FAM methodology.

.11 Other auditor considerations may arise where other auditors plan to use the work being performed, as discussed in FAM 630, especially in areas where the auditor makes decisions based on significant auditor judgment. In these cases, the auditor should consider the needs of, and consult with, other auditors in a timely manner. If the auditor plans to depart from a procedure expressed by use of "should" in the FAM, the auditor should provide an opportunity for the other

[43]In the FAM, control activities include controls within the control environment, entity risk assessment, information and communication, and monitoring components that directly address risks of material misstatement at the assertion level (see FAM 360.19).

auditors to review the documentation of the explanations for these departures and the alternative procedures performed to achieve the requirement.

.12 As audit work is performed, the auditor may become aware of possible control deficiencies; significant deficiencies; material weaknesses; noncompliance with provisions of applicable laws, regulations, contracts, and grant agreements; and misstatements, fraud, abuse, or other matters that should be communicated to the entity under audit, to the IG if the auditor is a contractor, and to those charged with governance. A structured method to document these issues aids in communicating them to the engagement team, entity management, and others soon after their discovery.

The auditor may document elements of potential findings, such as the nature of the condition and, if appropriate, the applicable criteria, cause, potential effect, and any recommendations for improvement throughout the audit. These elements and related reporting are discussed in GAGAS (2018) 6.25 through 6.28 and in FAM 580.80 through .82. The auditor may discuss these matters with entity management as the conditions are identified to inform management timely and to provide assurance that information is accurate and complete, rather than waiting until the exit conference.

295 A – Potential Inherent Risk Factors

.01 Listed below are characteristics of events or conditions that may affect the susceptibility of assertions to misstatement due to fraud or error (i.e., potential inherent risk factors). Some of these may affect many accounts and assertions; others may affect only one account or assertion. Although it is not all inclusive, this section assists the auditor in assessing risks of material misstatement as discussed in FAM 265. The auditor should evaluate any other relevant factors.

.02 **Nature of the Entity's Programs and Operations**

a. Programs are significantly affected by new/changing laws and regulations, economic factors, environmental factors, or a combination of these.

b. Contentious or difficult accounting issues are associated with the administration of a significant program(s).

c. Major uncertainties or contingencies, including long-term commitments, relate to a particular program(s).

d. New (in existence less than 2 years) or changing (undergoing substantial modification or reorganization) programs lack written policies or procedures, lack adequate resources, have inexperienced managers, and generally have considerable confusion associated with them.

e. Programs that are being phased out (being eliminated within 1 or 2 years) lack adequate resources, personnel motivation, and/or interest.

f. Significant programs have a history of improper administration, affecting operating activities.

g. Significant programs have a history of inadequate financial management causing management to resort to extensive, costly, time-consuming, ad hoc efforts to prepare financial statements by the required deadline.

h. Management faces significant pressure to obtain additional funding necessary to stay viable and maintain levels of service considering the financial or budgetary position of a program, including the need for funds to finance major research and development or capital expenditures.

i. Management faces significant pressure to "use or lose" appropriated funds in order to sustain future funding levels.

j. Partisan politics between competing political parties or factions or constituent groups create conflict and a lack of stability within the entity or its programs.

k. Unusually rapid growth occurs in a program.

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

m. Responsibilities for significant sensitive assets or proprietary information (national security, tax, health, etc.).

.03 **History of Significant Audit Adjustments**

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

.04 **Nature of Material Transactions and Accounts**

a. New types of transactions exist.

b. Significant transactions with related parties, disclosure entities, and public-private partnerships, and/or significant unusual transactions, exist.

c. Classes of transactions or accounts are

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

d. Accounts have complex underlying calculations or accounting principles.

e. Accounts have underlying activities, transactions, or events that are operating under severe time constraints.

f. Significant interagency transactions or revenue sources create incentives to shift costs or otherwise manipulate accounting transactions.

g. Accounts have activities, transactions, or events that involve the handling of unusually large cash receipts, cash payments, or wire transfers.

h. Inventory or equipment have characteristics such as small size, high value, high demand, marketability, or lack of ownership identification that make them easily converted to cash (for example, pharmaceutical inventory or military equipment with high street values).

i. Assets such as food stamps, benefits vouchers, commodities, supplies, or materials are easily converted to cash.

j. Assets such as cars, computers, and telephones are susceptible to personal, nonprogram/nongovernment use.

k. Many payments are sent to post office boxes.

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

295 B – Potential Control Environment, Entity Risk Assessment, Information and Communication, and Monitoring Deficiencies

.01 The specific conditions listed below may indicate deficiencies in the control environment, entity risk assessment, information and communication, and monitoring components, as well as the potential for fraud. The auditor may use this section when evaluating the design of the control environment, entity risk assessment, information and communication, and monitoring components as described in FAM 260. The auditor also may evaluate any other relevant factors and conditions. The Green Book and AU-C 315.A276 provide additional guidance for understanding these components of internal control. The auditor may evaluate these factors for the entire entity or by location.

Control Environment

.02 **Communication and Enforcement of Integrity and Ethical Values (Green Book 1.01 through 1.10)**

a. Management and those charged with governance have not established, exhibited, and communicated throughout the entity an appropriate "tone at the top," including explicit guidance about what is right and wrong.

b. Management and those charged with governance have not established a formal code of conduct or other policies regarding acceptable practices, conflicts of interest, or expected standards of ethical behavior.

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

d. Management covers up bad news rather than making full disclosure as quickly as possible.

e. Management does not quickly address signs that problems exist.

f. Management and employees feel pressure to cut corners or not follow established controls.

g. High decentralization leaves top management unaware of actions taken at lower organizational levels and thereby reduces the chances of management detecting errors and fraud.

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

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

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

k. Management and employees feel pressure to meet performance targets or deadlines that are unrealistic.

l. Management is under undue pressure from the administration to attain an unmodified opinion on the financial statements, despite significant internal control deficiencies.

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

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

o. Management has strained relationships with the IG, its current or predecessor external auditors, or both.

p. Management does not encourage and consider employee suggestions.

.03 **Commitment to Competence (Green Book 4.01 through 4.04)**

a. Management has not analyzed jobs to determine the knowledge and skills needed.

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

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

d. Inexperienced or incompetent accounting personnel are responsible for transaction processing.

e. The number of supervisors is inadequate or supervisors are inaccessible.

f. Key financial staff members have excessive workloads.

.04 **Management's Philosophy and Operating Style (Green Book 1.02 through 1.05)**

a. Management lacks concern about internal control and the environment in which specific controls function.

b. Management demonstrates an aggressive approach to risk taking.

c. Management demonstrates an aggressive approach to accounting policies. For example, management makes significant changes in allowances for uncollectible accounts that may be tied to performance measures in an effort to improve collections.

d. Management has a history of completing significant or unusual transactions near year-end, including transactions with disclosure entities, related parties, and public-private partnerships.

e. Management makes numerous adjusting journal entries, especially at year-end.

f. The process for preparing the financial statements is complex and includes many reclassifications and last-minute changes.

g. Management is reluctant to (1) consult auditors/consultants on accounting issues, (2) adjust the financial statements for misstatements, or (3) make appropriate disclosures.

h. Management displays a significant disregard for regulatory, legal, or oversight requirements or for IG, GAO, congressional authorities, or others charged with governance.

i. Top-level management lacks the financial experience/background necessary for the positions held.

j. Management is slow to respond to crisis situations in either operating or financial areas.

k. Management uses unreliable and inaccurate information to make business decisions.

l. Unexpected reorganization or replacement of management staff or consultants occurs frequently.

m. Management and personnel in key areas (such as accounting, information systems, and internal auditing) have a high turnover.

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

o. Management has publicly disclosed overly optimistic information on performance of programs and activities.

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

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

r. Financial arrangements/transactions are unduly complex.

s. There is a lack of adequate interaction between senior management and operating management, particularly those in geographically dispersed locations.

t. Management attitude toward information systems and accounting functions is that these are necessary “bean counting” functions rather than a vehicle for exercising control over the entity’s activities or making better decisions.

u. Management is motivated to engage in fraudulent financial reporting because of substantial political pressure that creates undue concern about reporting positive financial accomplishments.

v. Management is dominated, either entity-wide or at a specific component, by a single person or small group without compensating controls, such as effective oversight by those charged with governance.

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

x. Management has significant grantee, cooperative agreement, or contractor relationships for which there appears to be no clear programmatic or governmental justification.

y. Management appears more concerned with an unmodified opinion on the financial statements than fixing significant deficiencies in its systems.

z. Management has difficulty meeting reporting deadlines.

.05 **Organizational Structure (Green Book 3.02 through 3.05)**

a. The organizational structure is inappropriate for the entity's size and complexity. General types of organizational structures include

- federal centralized (managed and controlled on a day-to-day basis by a centralized system),
- federal decentralized (managed and controlled on a day-to-day basis by field offices or staffs),
- participant administered (managed and controlled on a day-to-day basis by a nonfederal organization), and
- other (managed and controlled on a day-to-day basis by some combination of the above or by other means).

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

c. Management has difficulty determining the organization or individual(s) that control(s) the entity, parts of the entity, or particular programs.

d. Recent changes in the management structure disrupt the organization.

e. Operational responsibilities do not coincide with the divisional structure.

f. Delegation of responsibility and authority is inappropriate.

g. A lack of definition and understanding of delegated authority and responsibility exists at all levels of the organization.

h. Policies and procedures are established at inappropriate levels.

i. A high degree of manual activity or spreadsheet use is required in capturing, processing, and summarizing data to prepare financial statements.

j. A single person or a small group dominates activities.

k. Entity officials could obtain financial or other benefits based on decisions made or actions taken in an official capacity.

.06 **Assignment of Authority and Responsibility (Green Book 3.06 through 3.08)**

a. The entity's policies regarding the assignment of responsibility and the delegation of authority for matters such as organizational goals and objectives; operating functions; and regulatory requirements, including responsibility for information systems and authorizations for changes, are inadequate.

b. Appropriate control-related standards and procedures are lacking.

c. The number of people, particularly in information systems and accounting functions, with requisite skill levels relative to the size and complexity of the operations is inadequate.

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

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

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

.07 **Human Resource Policies and Practices (Green Book 4.05)**

a. Human resource policies for hiring and retaining capable people are inadequate.

b. Policies and procedures for hiring, promoting, transferring, retiring, and terminating personnel are inadequate.

c. Training programs do not adequately offer employees the opportunity to improve their performance or encourage their advancement.

d. Written job descriptions and reference manuals are inadequate or inadequately maintained.

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

f. Policies on employee supervision are inappropriate or obsolete.

g. Management does not take remedial actions in response to departures from approved policies and procedures.

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

i. Management does not adequately screen job applicants who will have access to assets susceptible to misappropriation.

j. Training regarding controls over payments to others, such as those for benefits, grants, and federal financial assistance, is inadequate.

k. Employees performing key control functions do not take vacations.

l. Management does not reassign work of key employees on vacation.

.08 **Management's Control Methods over Budget Formulation and Execution**

a. Management provides little or no guidance material and instructions to those preparing the budget information.

b. Management and employees do not understand the budget review, approval, and revision processes.

c. Management demonstrates little concern for reliable budget information.

d. Management participation in directing and reviewing the budget process is inadequate.

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

f. Management has not developed adequate planning and reporting systems that set forth management's plans and the results of actual performance.

g. Employees use inadequate methods to identify the status of actual performance and exceptions from planned performance and communicate them to the appropriate levels of management.

h. The entity has reported noncompliance, including violations of the Antideficiency Act, and purpose, time, or other budget-related restrictions.

.09 **Management's Control Methods over Compliance with Laws, Regulations, Contracts, and Grant Agreements**

a. Management is unaware of the applicable laws, regulations, contracts, and grant agreements and potential problems.

b. A mechanism to inform management of the existence of illegal acts does not exist.

c. Management neglects to react to identified instances of noncompliance with laws, regulations, contracts, and grant agreements.

d. Management is reluctant to discuss its approach toward compliance and the reasonableness of that approach.

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

f. FMFIA reports; congressional reports; consultants' reports; and prior audits/evaluations by GAO, the IG, the internal auditor, or others disclose repeated instances of noncompliance or compliance control deficiencies.

g. Management is reluctant to provide evidential matter necessary to evaluate whether noncompliance with laws, regulations, contracts, and grant agreements has occurred.

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

i. Policies and procedures for complying with applicable laws, regulations, contracts, and grant agreements are weak.

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

k. Management does not have an effective legal counsel.

.10 **Participation by Those Charged with Governance (Green Book 2.02, 2.05, and 2.06)**

a. Those charged with governance demonstrate little concern about controls and how and when management addresses internal and external auditors' recommendations.

b. Those charged with governance have little involvement in and provide little scrutiny of activities.

c. Little interaction occurs between those charged with governance and the IG and internal and external auditors.

d. Those charged with governance demonstrate little concern for compliance with applicable laws, regulations, contracts, and grant agreements.

.11 **Succession and Contingency Plans and Preparation (Green Book 4.06 through 4.08)**

a. Management does not have defined succession and contingency plans for key roles.

b. Management's succession plan does not define key roles.

c. Management has not chosen succession candidates.

d. Management does not provide training to succession candidates before they assume the key roles.

e. Management does not assess whether the service organization can fulfill assigned responsibilities of key roles in the entity or whether the service organization can continue in these key roles.

f. Management has not defined contingency plans for assigning responsibilities if a key role in the entity is vacated.

.12 **Enforce Accountability and Consider Excessive Pressure (Green Book 5.01 through 5.08)**

a. Management does not enforce accountability of individuals performing their internal control responsibilities.

b. Management does not have performance appraisals or provide disciplinary actions.

c. Management provides incentives that are not aligned with the entity's standards of conduct.

d. Management does not hold service organizations accountable for their assigned internal control responsibilities.

e. Management does not communicate the objectives of the entity and their related risks, the entity's standards of conduct, the role of the service organization in the organizational structure, the assigned responsibilities and authorities of the role, and the expectations of competence for its role that will enable the service organization to perform its internal control responsibilities.

f. Management does not take corrective actions to enforce accountability for internal control in the entity.

g. Management does not adjust excessive pressures on personnel in the entity.

h. Management does not evaluate pressure on personnel to help personnel fulfill their assigned responsibilities in accordance with the entity's standards of conduct.

Entity Risk Assessment

.13 **Defining Objectives (Green Book 6.02 through 6.07)**

a. Management has not defined or communicated its overall objectives to employees or those charged with governance, such as oversight committees.

b. Management does not have a strategic plan, or the strategic plan is not consistent with the entity's objectives.

c. The strategic plan does not address high-level resource allocations and priorities.

d. The strategic plan, budgets, objectives, or a combination of these are inconsistent.

e. Management has not defined activity-level objectives for all significant activities, or the objectives are inconsistent with each other or with the overall objectives.

f. Objectives do not include measurement criteria.

.14 **Identifying, Analyzing, and Responding to Risks (Green Book 7.01 through 7.09)**

a. Management does not have a formal risk assessment process.

b. For financial reporting purposes, management has not identified risks relevant to the preparation of the financial statements in accordance with U.S. GAAP. Risks relevant to reliable financial reporting also relate to specific events or transactions. See AU-C 315.A276, item 9, for examples of circumstances that could cause risks relevant to financial reporting to arise or change, such as (1) changes in the operating environment; (2) new personnel; (3) new or revamped information systems; (4) rapid growth; (5) new technology; (6) new programs, activities, strategies, or products; (7) restructuring or reorganization; (8) new accounting pronouncements; and (9) use of information technology.

c. Management has not adequately identified risks to the entity's ability to comply with applicable laws, regulations, contracts, and grant agreements, including maintaining effective controls over compliance.

d. Management has not adequately identified risks to the entity's ability to prevent and detect fraud.

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

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

g. Once risks are identified, management has not adequately analyzed the risks to estimate their significance, including considering the magnitude of impact, likelihood of occurrence, and nature of the risks.

h. Once risks are identified and analyzed, management has not adequately designed specific actions to respond to the risks.

.15 **Identifying, Analyzing, and Responding to Significant Changes (Green Book 9.01 through 9.05)**

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

b. Information systems are not modified in response to changing conditions.

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

d. Management is unresponsive to changing conditions.

Information and Communication

.16 **Use Quality Information (Green Book 13.01 through 13.06)**

a. Management has not identified all of the information requirements necessary to achieve the entity's objectives and address risks.

b. Management uses outdated data or data from unreliable sources in its decision-making.

c. Employees are not able to understand, make use of, or timely access the information they need to complete their work assignments.

d. Management demonstrates a lack of interest in correcting information that is incomplete or inaccurate.

.17 **Internal Communication (Green Book 14.01 through 14.08)**

a. The system for communicating policies and procedures is ineffective.

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

c. Channels of communication for reporting suspected improprieties are inappropriate.

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

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

f. Management is not receptive to employee suggestions of ways to enhance productivity and quality or control.

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

.18 **External Communication (Green Book 15.01 through 15.09)**

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

b. The entity's website is not used effectively as a communication tool.

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

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

e. Management has not established an open two-way line of communication with external parties to allow quality information to be sent and received.

Monitoring

.19 **Ongoing Monitoring (Green Book 16.04 through 16.08)**

a. Management is not sufficiently involved in reviewing the entity's performance or its controls.

b. Management control methods are inadequate for investigating unusual or exceptional situations and for taking appropriate and timely corrective action.

c. The entity does not have an effective hotline for reporting fraud, violations of laws and regulations, and control deficiencies.

d. The entity does not have an effective internal audit function.

e. Management's follow-up action is untimely or inappropriate in response to communications from external parties, including complaints, notification of errors in transactions with parties, and notification of inappropriate employee behavior.

f. Management does not review whether periodic comparisons of amounts recorded in the financial management system with physical assets are performed on a timely basis and whether any differences are resolved timely.

g. Management does not monitor whether reviews to prevent large numbers of duplicate payments and other improper payments are performed on a timely basis.

h. Management does not effectively monitor that policies for developing and modifying financial management systems and control activities are reviewed on systematic basis to obtain reasonable assurance of operating effectiveness.

i. Management does not monitor the legal (or other appropriate) department's oversight of compliance with the entity's code of conduct, which may include employees' periodic acknowledgment of compliance.

j. Management does not adequately monitor whether significant activities that have been outsourced to contractors or information systems components maintained by contractors are reviewed on a timely basis.

.20 **Separate Evaluations under FMFIA and FFMIA**

a. Management displays a disregard for complying with FMFIA or FFMIA, or both.

b. Management displays a combative attitude toward the FMFIA or FFMIA process, or both.

c. Employees without appropriate skills manage the FMFIA or FFMIA process, or both.

d. Management did not establish an organizational structure to effectively implement, direct, and oversee the FMFIA or FFMIA process, or both. OMB Circular No. A-123 requires that entities establish a senior management council and a senior assessment team or equivalent structures. The oversight

of the assessment process may also be incorporated into existing offices or functions within the organization that currently monitor the effectiveness of the organization's internal control.

e. Management did not effectively

- evaluate controls at the entity level or consider the components of internal control based on criteria established under FMFIA (OMB Circular No. A-123 and Green Book) or
- assess whether its financial management systems comply substantially with the requirements of FFMIA based on guidance provided in OMB Circular No. A-123, appendix D.

f. Management did not include deficiencies identified in its assessments or identified by the auditor that should have been reported in its FMFIA or FFMIA reports.

.21 **Management's Assessment of Internal Control over Financial Reporting**

a. Management did not use a reasonable approach to determine the scope of the assessment. The scope of the assessment would include identifying significant financial reports, processes, controls, and transactions.

b. Management did not adequately evaluate and document the significant processes and controls, including documentation of decisions on determining the scope, materiality, testing methodology, and other significant decisions related to this assessment.

c. Management did not use a reasonable approach to determine what, when, where, and how to test controls, or did not properly document the tests and results.

d. Management did not use the results of its testing to support its conclusion on whether controls over financial reporting were designed, implemented, and operating effectively.

e. Management's assurance statement did not appropriately describe any scope limitations and was not consistent with the evidence gathered during the testing process, including information gathered during the financial statement audit.

f. Management does not have a process in place for prompt and proper implementation of corrective actions to resolve deficiencies in internal controls, including material weaknesses.

g. Auditors note deficiencies were not included in management's assessment of internal control over financial reporting.

.22 **Reporting Deficiencies (Green Book 17.02 through 17.04)**

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

b. The entity does not report deficiencies to the person with direct responsibility and to a person at least one level higher or to more senior management.

c. Management does not correct deficiencies timely.

d. Management does not investigate underlying causes of problems.

e. Management does not follow up to determine whether the necessary corrective action has been taken.

.23 **The Effectiveness of Other Auditors**[44]

a. Auditors are responsible for making operating decisions or for controlling other original accounting work subject to audit.

b. Audit management personnel are inexperienced for the tasks assigned.

c. Auditors have minimal training, including little or no participation in formal courses and seminars and inadequate on-the-job training.

d. Auditors have inadequate resources to conduct audits and investigations effectively.

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

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

g. Performance reviews of audit staff are nonexistent or irregular.

h. The audit planning process is nonexistent or inadequate, including little or no concentration on significant matters and little or no consideration of the results of prior audits and current developments.

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

j. Audit documentation, such as audit strategy, audit plans/procedures, evidence of work performed, and support for audit findings, is incomplete.

k. An inadequate mechanism is used to keep the entity head, the Congress, and others charged with governance informed about problems, deficiencies, and the progress of corrective action.

l. Audit coverage over payments made by others, such as state or local governments, for benefits, grants, and federal financial assistance is inadequate.

m. The auditor does not adequately review IS controls, including general and application controls.

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

o. The audit organization does not have an adequate quality control system, including monitoring.

p. The audit organization does not have a peer review every 3 years.

[44]The term other auditors refers to auditors other than the audit organization performing the entity's financial statement audit as group auditor. These other auditors may be part of the entity's monitoring controls. See FAM 630 and 645 for further discussion of using the work of other auditors.

295 C – An Approach for Multiple-Location Audits

.01 This section provides one approach for stratifying the locations and selecting audit samples for multiple-location audits. This method assumes that the auditor has determined that it is not practical to make a centralized selection and that the auditor identifies locations to be tested each year because of identified risks of material misstatement. If the auditor uses other methods to select locations for testing, the basis for doing so must be provided to the reviewer in a timely manner to allow any issues to be promptly identified and resolved. The auditor generally should consult with an audit sampling specialist when selecting locations.

Stratifying the Locations

.02 Unless the auditor uses a monetary unit sampling (MUS) method that automatically stratifies the population by the dollar amount of transactions, the auditor stratifies the locations by separating them into an appropriate number of relatively homogeneous groups or strata. Stratification can improve the efficiency of the audit sample result through reducing the uncertainty of the estimate by grouping items together that are expected to behave similarly with respect to the audit measure (usually misstatements). Stratification can also be used to provide items of special interest additional coverage in the audit sample. The stratification may be based on relative size or qualitative factors, such as risk of material misstatement. Criteria for stratifying may include estimates of one or more of the following relative factors:

- the dollar amount of assets;
- the dollar amounts of revenue and expenses incurred or processed at the location;
- the number of personnel, where payroll costs are significant;
- the dollar amount of appropriations;
- a concentration of specific items (such as a stratum consisting of significant inventory storage locations, of which those selected will undergo only inventory procedures);
- the nature and extent of inherent and control risk, including fraud risk and sensitive matters or the turnover of key management; and
- special reporting requirements, such as separate reports, special disclosures, or supplementary schedules.

.03 For example, the auditor may stratify locations, based on the amount of total assets, into the following strata: (1) individually material locations (top stratum), (2) relatively significant locations (intermediate stratum), and (3) relatively insignificant locations (bottom stratum). If an entity has 100 locations and if the auditor determines that total assets is the relevant criterion for stratifying locations, the first three columns of table FAM 295 C.1 may represent an acceptable stratification.

Selecting Locations

.04 The auditor may select locations for testing using one of the following methods for each stratum:

- **MUS or classical variables sampling method** using a multistage approach.
- **Another audit sampling method** the auditor expects will be representative. The auditor generally should consult with an audit sampling specialist if classical variables sampling or another sampling method is used.
- **Nonstatistical selection method** when the auditor determines that it is effective to select locations using auditor's judgment. With this method, the auditor cannot project the results of the tested locations to the entity as a whole. Thus, the auditor should apply substantive analytical procedures, other substantive tests, or both to the locations not tested, unless those locations are immaterial in total to the entity as a whole.

These methods are described in more detail in FAM 480.

.05 Table FAM 295 C.1 illustrates a possible MUS sample for each stratum, using performance materiality of $3 million, no expected misstatement, and 95 percent assurance. For an MUS sample, the sampling interval would be $1 million, and the preliminary estimate of the sample size would be 100 ($100 million divided by $1 million). FAM 400 provides additional information on calculating the amounts in the table and the various selection methods.

Table FAM 295 C.1: Example of MUS Sampling

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

[a]The preliminary estimate of sample size is calculated by dividing the total balance by the sampling interval of $1,000,000. See FAM 400 for additional information concerning audit sampling.

[b]The actual number of items tested in the top stratum may be fewer than the preliminary estimate of sample size because a top stratum selection may include more than one sample item. For example, if the implicit sampling interval is $1,000,000, a $10 million selection would include 10 sample items.

Testing the Items

.06 The auditor determines the number of items to be tested at each location and then selects and tests those items. For each line item/account, the auditor determines the total number of items to be tested, based on the applicable selection method and population, tolerable misstatement, and the level of assurance desired, as described in FAM 480 and FAM 495 D.

.07 The auditor may perform analytical and other procedures, as applicable, for both the locations selected and those not selected. The auditor generally should perform supplemental analytical procedures, including comparisons of locations with each other, with other years' information, and with nonfinancial measures for all locations, regardless of the selection method.

FAM 400 provides guidance on substantive and supplemental analytical procedures. Specific matters noted during the audit—for example, cutoff misstatements at one or more locations—may warrant increased or different audit procedures at locations not previously selected for testing.

.08 In evaluating the result of an audit sample, the auditor should estimate the effects, both quantitative and qualitative, on the financial statements as a whole of any misstatements noted, as discussed in FAM 480 and FAM 540. In testing selected locations, in addition to the issues concerning evaluation of audit samples in those sections, the auditor, using professional judgment, generally should apply the following additional procedures upon finding misstatements or control deviations:

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

b. Ask management to identify the cause of the misstatements and whether similar misstatements are likely to have occurred at locations not tested.

c. Assess management's identification of cause.

d. Determine whether the misstatements indicate that there is a control deficiency. If so, determine whether the control deficiency applies only to the location tested or to all locations. Determine whether control deficiencies indicate a need to change the control risk assessment, risk of material misstatement, or substantive procedures, either for the location or overall.

e. Obtain evidence to test management's evaluation of whether the same or similar types of misstatement exist at other locations, including locations not tested. If the evidence is highly persuasive that the misstatement does not exist at other locations and the audit director concurs, the auditor may treat the effect on the entity the same as that on the location. See FAM 480.35 for a discussion of deciding whether evidence is highly persuasive.

If the misstatement is not isolated to the location, ask management to investigate whether there is evidence that the incidence rate throughout the entity is different from the incidence rate in the location tested. If such evidence exists, the auditor generally should obtain evidence of the incidence rate throughout the entity and determine the effect on the entity's financial statements. If no such evidence exists, the auditor should project the misstatement identified in the location tested to the entire entity in determining the potential amount of misstatement that exists in the financial statements. The audit sampling specialist generally should review these projections.

.09 The auditor should evaluate the sufficiency of audit procedures applied. The auditor should use professional judgment and should identify all relevant factors to determine whether the audit objectives are met in the specific circumstances.

295 D – Considerations for Performing Interim Substantive Testing

.01 The auditor may decide to perform **substantive** tests for material line items, accounts, note disclosures, or classes of transactions as of a date before the date of the financial statements. (Note: Interim substantive testing is generally performed on statement of net cost line items or accounts.) If the auditor performs interim tests, the auditor should also apply further substantive procedures combined with tests of controls that cover the period between the interim testing date and the date of the financial statements, often referred to as the roll-forward period, and provide a reasonable basis for extending audit conclusions from the interim date to year-end.[45]

.02 Because evidence obtained as of the year-end provides more assurance than evidence obtained as of an interim date, the risk of material misstatement generally increases as the length of the roll-forward period increases. The auditor should assess the risk of material misstatement due to fraud or error (inherent risk and control risk) in determining whether substantive and control tests of the roll-forward period can be designed to provide a reasonable basis for extending the audit conclusions from the interim testing date to year-end.

.03 By performing interim tests before year-end, the auditor may be able to

- more quickly address the risks of material misstatement, including audit and accounting issues, such as problem areas and complex or unusual transactions, enabling the entity to either correct misstatements or the auditor to modify the audit strategy and audit plan or procedures;
- complete the audit and issue the audit report earlier; and
- improve staff utilization and enable a smaller number of staff members to perform the audit by allocating the total audit hours over a longer period before the report issuance date.

.04 Interim testing typically involves greater detection risk than testing as of year-end. However, in some cases, the auditor may be able to perform interim tests depending on the auditor's assessment of the factors in FAM 295 D.06.

.05 If the auditor finds control deviations in the tests of controls during interim tests, the auditor uses professional judgment, considering the nature, cause, and estimated effects of the deviations, to determine whether to revise the preliminary risk assessments, audit strategy, and audit plan or procedures, including decisions regarding the nature, extent, and timing of substantive procedures.

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

- **The assessment of risk of material misstatement.** The auditor should evaluate the risk of material misstatement during the roll-forward period, including relevant factors such as business conditions that may make management more susceptible to pressures, providing a rationale for

[45]The auditor may also perform audit procedures on September 30 interim amounts to be included in the consolidated financial statements of the U.S. government for federal entities with different year-ends.

misstating the financial statements. As the risk of material misstatement increases, the auditor generally increases the extent of the procedures applied to the roll-forward period or year-end, possibly making interim testing much more costly than only testing the year-end balances.

- **The anticipated comparability of risk of material misstatement and the nature of the items tested from the interim testing date to year-end.** The auditor may more easily extend the audit conclusions from the interim date to the year-end date if the risk of material misstatement does not increase from the interim date to the year-end date and if the nature of the items tested is similar at both dates.
- **(For balance sheet accounts) The amount of the line item or account balance at the interim testing date in relation to the expected year-end balance.** A significant increase in the line item or account balance between interim and year-end dates would diminish the auditor's ability to extend the audit conclusions to the year-end. In addition, applying substantive interim tests to a large line item or account balance may be inefficient if the year-end balance is much lower than the balance at the interim date.
- **The length of the roll-forward period.** The longer the roll-forward period, the more difficult it is to control the increased risk of material misstatement. The auditor generally should not use a roll-forward period longer than 3 months for assertions in account balances with significant activity during the roll-forward period. However, the auditor may use a longer roll-forward period in certain situations, depending on the auditor's assessment of the anticipated activity during the roll-forward period as discussed below.
- **The predictability of transaction activity during the roll-forward period.** Interim testing generally decreases in effectiveness and efficiency as the level of transaction activity during the roll-forward period differs from expectations, for example, if there are large or unusual transactions during this period or expected transactions did not occur.
- **The ease with which audit procedures can be applied to test the transactions or controls during the roll-forward period.** As the difficulty of such procedures increases, the efficiency of interim testing generally decreases.
- **The availability of information to test roll-forward period activity using substantive analytical procedures, detail tests, tests of controls, or a combination of procedures.** If sufficient information is not available, interim testing is not appropriate.
- **The timing of the audit, staffing and scheduling requirements, and reporting deadlines.** Tight deadlines or staff availability for performing audit procedures at the year's end may necessitate interim testing.

.07 The auditor should document in the LIRA form or equivalent the material line items, accounts, note disclosures, and classes of transactions, and the assertions, to which interim substantive testing is applied. The auditor should document the basis for concluding that the use of interim testing is appropriate in the audit strategy.

.08 If interim testing is planned, see FAM 495 C for guidance for interim testing.

295 E – Effect of Risk of Material Misstatement on Extent of Audit Procedures

.01 The concepts of materiality and risk interrelate and sometimes are confused. The auditor determines materiality based on the users' perceived concerns and needs. The auditor also assesses risk of material misstatement based on, for instance, knowledge of the entity; its business (purpose); applicable laws, regulations, contracts, and grant agreements; and internal control.

.02 The auditor uses both materiality and risk in (1) determining the nature, extent, and timing of audit procedures and (2) evaluating the results of audit procedures. The evaluation of risk usually **does not** affect materiality. However, risk affects the extent of testing needed. The higher the auditor's assessment of risk of material misstatement, the higher the required level of substantive assurance from the audit procedures. The consideration of inherent risk is discussed in FAM 265, and the consideration of control risk and risk of material misstatement (combined inherent risk and control risk) is discussed in FAM 370. Use of risk in determining sample size is discussed in FAM 470.

.03 As an example, assume that the auditor is testing accounts receivable using MUS techniques described in FAM 480. Pertinent data for this test are

- accounts receivable total $2.5 million,
- tolerable misstatement is $100,000, and
- no misstatements are expected.

If the auditor assesses risk of material misstatement as low, the sample size would be 25 items. If the auditor assesses the risk of material misstatement as high, the sample size would be 75 items. The increase in risk tripled the sample size **with the same tolerable misstatement**.

295 F – Types of Information System Controls

.01 As discussed in FAM 270, when relevant control activities depend on information system processing, the auditor should assess IS controls using an appropriate methodology. The auditor should understand the design of the general controls identified to the extent necessary to conclude tentatively whether these controls are likely to be effective. If they are likely to be effective, the auditor should test IS controls using an appropriate methodology (see FAM 360). An information technology specialist may assist the auditor in understanding technical aspects of information systems and IS controls.

.02 IS controls consist of those internal controls that are dependent on information system processing and can be classified into three types:

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

General Controls

.03 General controls (implemented at the entity-wide, system, and application levels) are the structure, policies, and procedures that apply to all or a large segment of an entity's information systems, including financial management systems. General controls help ensure the proper operation of information systems by creating the environment for effective operation of application controls. Ineffective general controls may prevent application controls from operating effectively and allow misstatements to occur and not be detected. General controls include the following:

a. **Security management** is the foundation of a security-control structure and is a reflection of senior management's commitment to addressing security risks. Security management programs should provide a framework and continuous cycle of activity for managing risk, developing and implementing effective security policies, assigning responsibilities, and monitoring the adequacy of the entity's IS controls. Without a well-designed security management program, security controls may be inadequate; responsibilities may be unclear, misunderstood, or improperly implemented; and controls may be inconsistently applied. Such conditions may lead to insufficient protection of sensitive or critical resources and disproportionately high expenditures for controls over low-risk resources.

b. **Logical and physical access controls** limit access or detect inappropriate access to computer resources (data, programs, equipment, and facilities), thereby protecting these resources against unauthorized modification, loss, and disclosure. Logical access controls require users to authenticate themselves (through the use of one or more authentication tokens such as passwords, smart cards, biometric data, etc.) and limit the files and other resources that authenticated users can access and the actions that they can execute. Physical access controls involve restricting physical access to computer resources and protecting them from intentional or unintentional loss or impairment.

c. **Configuration management** involves the identification and management of security features for all hardware, software, and firmware[46] components of an information system at a given point and systematically controls changes to that configuration during the system's life cycle. Configuration management controls that are designed and implemented effectively prevent unauthorized or untested changes to critical information system resources at each system sublevel (i.e., network, operating systems, and infrastructure applications) and provide reasonable assurance that systems are securely configured and operated as intended.

   In addition, configuration management controls that are designed and implemented effectively provide reasonable assurance that software programs and changes to software programs go through a formal, documented systems development process that identifies all changes to the baseline configuration. To reasonably assure that changes to applications are necessary, work as intended, and do not result in the loss of data or program integrity, such changes should be authorized, documented, tested, and independently reviewed.

d. **Segregation of duties** includes having policies, procedures, and an organizational structure to manage who can control key aspects of computer-related operations and thereby prevents unauthorized actions or unauthorized access to assets or records. Segregation of duties involves segregating work responsibilities so that one individual does not control all critical stages of a process. Effective segregation of duties is achieved by splitting responsibilities between two or more individuals or organizational units. In addition, dividing duties this way diminishes the likelihood that errors and wrongful acts will go undetected because the activities of one group or individual will serve as a check on the activities of the other.

e. **Contingency planning** protects critical and sensitive data and provides for critical operations to continue without disruption or be promptly resumed when unexpected events occur. Contingency planning involves protecting against losing the capability to process, retrieve, and protect electronically maintained information. Effective contingency planning is achieved by having procedures for protecting information resources and minimizing the risk of unplanned interruptions and a plan to recover critical operations should interruptions occur. In addition, recovery plans should be tested periodically in disaster simulation exercises to determine whether they will work as intended.

FISCAM has detailed guidance on evaluating and testing general controls.

.04 General controls are established at the entity-wide, system, and application levels.

- In evaluating general controls at the entity-wide or system level, the auditor and the IS controls auditor may evaluate overall access control. For instance, the IS controls auditor may evaluate the entity's use of security access software that provides authentication services to multiple systems, including its proper implementation.

[46]Firmware is a program or programs recorded in permanent or semipermanent computer memory.

- When evaluating general controls at the application level, the auditor and the IS controls auditor may evaluate access controls that limit access to particular applications and related computer files, such as restricting access to payroll applications and related files (such as the employee master file and payroll transaction files) to authorized users.
- Finally, the auditor and the IS controls auditor may evaluate the security built into the application itself to further restrict access. This security is usually accomplished through menus and other restrictions programmed into the application software. Thus, a payroll clerk may have access to payroll applications but may be restricted from access to a specific function, such as reviewing or updating payroll data on payroll department employees.

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

Application Controls

.06 Application controls are controls that are incorporated directly into software programs, or applications, to help ensure the validity, completeness, accuracy, and confidentiality of transactions and data during information system processing. Application controls, sometimes referred to as business process controls, include controls over

- input,
- processing,
- output,
- master data,
- application interfaces, and
- data management system interfaces.

The effectiveness of application controls depends on the effectiveness of entity-wide and system-level general controls. Deficiencies in entity-wide and system-level general controls can permit unauthorized changes to business process applications and data that can circumvent or impair the effectiveness of application controls. An effective application control environment includes

- general controls implemented at the application level (i.e., security management, access controls, configuration management, segregation of duties, and contingency planning);
- controls over transaction data input, processing, and output as well as master data maintenance;
- interface controls over the timely, accurate, and complete processing of information between information systems; and

- controls over the data management systems.

.07 FISCAM uses control categories that complement the methodology used in the FAM. Most of the following categories relate to the assertions.

- **Validity controls.** This category relates to the assertion of existence or occurrence. Validity controls provide reasonable assurance (1) that all recorded transactions actually occurred (are real), relate to the organization, and were properly approved in accordance with management's authorization and (2) that output contains only valid data. A transaction is valid when it has been authorized (for example, buying from a particular supplier) and when the master data relating to that transaction are reliable (for example, the name, bank account, and other details on that supplier). Validity includes the concept of authenticity, including prevention or detection of duplicate transactions. Examples of validity controls are one-for-one checking and matching.
- **Completeness controls.** This category relates to the assertion of completeness and deals with whether all valid transactions are recorded. Completeness controls provide reasonable assurance that all transactions that occurred are input into the system, accepted for processing, processed once and only once by the system, and properly included in output. Completeness controls include the following key elements:
  - transactions are completely input;
  - valid transactions are accepted by the system;
  - rejected transactions are identified, corrected, and reprocessed; and
  - all transactions accepted by the system are processed completely.

  The most common completeness controls in applications are batch totals, sequence checking, matching, duplicate checking, reconciliations, control totals, and exception reporting. Reconciliations not only help detect misstatements relating to transaction completeness, but also identify the cutoff and summarization misstatements associated with both the existence or occurrence and completeness assertions.
- **Accuracy controls.** This category relates to the assertion of valuation or allocation, which deals with whether transactions are recorded at correct amounts. This control category, however, is not limited to valuation and also includes controls designed to properly classify transactions. Accuracy controls should provide reasonable assurance that transactions are properly recorded, with the correct amounts/data, and on a timely basis (in the proper period); key data elements input for transactions are accurate; data elements are processed accurately by applications that produce reliable results; and output is accurate.

  Accuracy control techniques include programmed edit checks (e.g., validations, reasonableness checks, dependency checks, existence checks, format checks, mathematical accuracy, range checks, etc.); batch totals; and check digit verification.
- **Confidentiality controls.** These controls should provide reasonable assurance that application data and reports and other output are protected against unauthorized access. Examples of confidentiality controls include

restricted physical and logical access to sensitive business process applications, data files, transactions, and output and adequate segregation of duties. Confidentiality controls also include restricted access to data reporting/extraction tools as well as copies or extractions of data files.

- **Availability controls.** These controls should provide reasonable assurance that application data and reports and other relevant business information are readily available to users when needed. These controls are principally addressed in application-level general controls (especially contingency planning).

User Controls

.08 User controls are portions of controls that are performed by people interacting with information systems. The effectiveness of a user control typically depends on information system processing or the reliability of information that information systems produce. A user control is considered both an IS control and a manual control if it depends on information system processing. For example, the effectiveness of a user control to review and follow up on exceptions typically depends on the reliability of the exception report that the information system produces through information system processing.

A user control is considered a manual control if it does not depend on information system processing. For example, the effectiveness of a user control to manually reconcile information that information systems produce may or may not depend on the reliability of the information used in the reconciliation, depending on the nature of the control. Additionally, the effectiveness of a user control to monitor the effective functioning of information systems and IS controls may or may not depend on the reliability of information that information systems produce.

If the auditor expects the effectiveness of a user control to reduce the risk of material misstatement, the auditor should understand the design of and test any related controls that support achieving the control objective of the user control. The extent to which it is necessary to assess related IS controls depends on the design of the user control and its control objective.

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

If the user control is a manual reconciliation of information that information systems produce, the auditor should obtain an understanding of the sources of the information being reconciled and how such information is produced to evaluate the design of the user control. Depending on the design of the manual reconciliation and its control objective, the auditor may or may not need to assess the application and general controls related to producing the information being reconciled. For example, the auditor may not need to assess the application or general controls related to producing the information being reconciled if the control objective is to provide an independent check on the

validity, accuracy, and completeness of the information system–processed data and the manual reconciliation is effectively designed to achieve this objective.

.09 In certain circumstances, user controls may be manual controls used to monitor the proper functioning of information systems and IS controls. For example, a user control to manually check the completeness and accuracy of information system processed transactions against manually prepared source records would be considered a manual control. However, it is important to note that the effectiveness of this manual control would be dependent on the effectiveness of the manual controls over the reliability of the manually prepared source records.

295 G – Budget Controls

.01 Budget controls are management's policies and procedures for managing and controlling the use of appropriated funds and other forms of budget authority. Budget controls are part of the internal controls covered in OMB audit guidance. During planning, the auditor should obtain an understanding of budget controls, as discussed in FAM 250 and 260.

.02 Certain controls may achieve both financial reporting and other control objectives. Accordingly, for efficiency, the auditor may coordinate obtaining an understanding of budget controls with obtaining an understanding of financial reporting, compliance, and relevant operations controls.

.03 **Budget authority** is authority provided by law to allow federal entities to enter into financial obligations that will result in immediate or future outlays involving government funds. The Congress provides an entity with budget authority and may place restrictions on the amount, purpose, and timing of the obligation or outlay of such authority.

.04 There are four basic forms of budget authority:

- **Appropriations.** The most common form of budget authority, appropriations are statutory authority that permits federal entities to incur obligations and to make payments from the Treasury for specified purposes. Appropriations do not represent cash actually set aside in the Treasury for purposes specified in the appropriation acts. Appropriations represent amounts that entities may obligate during the period specified in the appropriation acts. Periods can be single year, multiyear, or no year.
- **Borrowing authority.** This is statutory authority that permits federal entities to borrow money and then to obligate against amounts borrowed. The amount to be borrowed may be definite or indefinite in nature, and the purposes for which the borrowed funds are to be used are stipulated by the authorizing statute.
- **Contract authority.** This is statutory authority that permits obligations to be incurred in advance of appropriations or in anticipation of receipts to be credited to a revolving fund or other account (offsetting collections). Contract authority is unfunded. Subsequent funding by an appropriation or by offsetting collections is needed to liquidate the obligations incurred under the contract authority.
- **Offsetting receipts and collections authority.** This is statutory authority that permits federal entities to obligate and expend the proceeds of offsetting receipts and collections. Offsetting receipts and collections are of a business-market-oriented nature and may include intragovernmental transactions, such as reimbursements for materials or services provided to other government entities. If, pursuant to law, they are credited to appropriations or fund expenditure accounts and are available for obligation without further congressional action, they are referred to as offsetting collections.

.05 Although the Congress provides budget authority to some federal entities annually in the appropriations act process, the Congress provides other federal entities with budget authority through laws other than annual appropriations acts,

or through permanent authorities that permit the entity to spend budget authority without further congressional action.

.06 For additional information and terminology on the federal budget process, consult GAO's *A Glossary of Terms Used in the Federal Budget Process* (GAO-05-734SP, September 2005).

295 H – List of General Laws

.01 The auditor should determine whether the significant provisions in the following laws have a direct effect on determining material amounts and disclosures in the financial statements (see FAM 245.03). The auditor generally should use the General Compliance Checklist in FAM 802 or equivalent to determine which of these legal provisions are significant for testing compliance. Following each listed law is the section in the FAM that contains the compliance summary for internal control testing and audit procedures for that law.

a. **Antideficiency Act (ADA**), as provided primarily in 31 U.S.C. chapters 13, 15. Provisions: 31 U.S.C. §§ 1341(a)(1)(A), (B); and 31 U.S.C. § 1517(a). See FAM 803.

b. **Federal Credit Reform Act of 1990 (FCRA)**, as provided in 2 U.S.C. §§ 661-661f. Provisions: 2 U.S.C. § 661c(b), (e). See FAM 804.

c. **Federal Debt Collection Authorities**, as provided in 31 U.S.C. chapter 37. Provisions: 31 U.S.C. § 3711; 31 U.S.C. § 3717(a), (b), (c), (e), (f); and 31 U.S.C. § 3719. See FAM 805.

d. **Prompt Payment Act (PPA)**, as provided in 31 U.S.C. chapter 39. Provisions: 31 U.S.C. § 3902(a), (b), (f); and 31 U.S.C. § 3904. See FAM 806.

e. **Pay and Allowance System for Civilian Employees**, as provided primarily in 5 U.S.C. chapters 51-59. Provisions: 5 U.S.C. § 5332; 5 U.S.C. § 5343; 5 U.S.C. § 5376; and 5 U.S.C. § 5383. See FAM 807.

f. **Civil Service Retirement Act (CSRA)**, as provided in 5 U.S.C. chapter 83. Provisions: 5 U.S.C. chapter 83, subchapter III. See FAM 808.

g. **Federal Employees Health Benefits Act (FEHBA)**, as provided in 5 U.S.C. chapter 89. Provisions: 5 U.S.C. chapter 89. See FAM 809.

h. **Federal Employees' Compensation Act (FECA)**, as provided in 5 U.S.C. chapter 81. Provisions: 5 U.S.C. chapter 81, subchapter I. FAM 810.

i. **Federal Employees' Retirement System Act (FERSA)**, as provided in 5 U.S.C. chapter 84. See FAM 811.

295 I – Examples of Auditor Responses to Fraud Risks

.01 As discussed in FAM 265, the auditor should respond to the risks of material misstatement due to fraud (fraud risks) at the financial statement and assertion levels. This section provides examples of auditor responses to fraud risks, including changing the nature, extent, or timing of audit procedures.

Examples of Auditor Responses to Fraud Risks Involving the Nature, Extent, or Timing of Audit Procedures

.02 Examples of auditor responses to fraud risks involving the nature, extent, or timing of audit procedures include the following:

a. Inquiring of management and other personnel involved in areas having fraud risks, such as risks related to any improper payments, to obtain their insights about those risks and whether and how controls mitigate those risks.

b. Inquiring of management regarding management's understanding of and response to the fraud risks that may exist at the entity's service organizations.

c. Inquiring of those charged with governance to obtain their insights about those risks and whether and how controls mitigate those risks.

d. Inquiring of additional members of management, such as program directors or center directors, or other nonaccounting personnel to assist in identifying issues and corroborating other evidential matter.

e. Using data-mining or other computer-assisted audit techniques to gather more extensive evidence about data contained in significant accounts. For example, the auditor can use computer software, such as Interactive Data Extraction and Analysis (IDEA), to select audit sample items from electronic files, locate items with specific characteristics (to perform substantive analytical procedures or make a nonstatistical selection), or test an entire population.[47]

f. Inspecting, or observing physical counts of, tangible assets (such as property, plant, and equipment) and certain inventories, for which other procedures may otherwise have been sufficient.

g. Conducting surprise or unannounced procedures, such as inventory inspections or cash counts on unexpected dates or at unexpected locations.

h. Inquiring of major suppliers or customers in addition to obtaining written confirmations, requesting confirmations of specific individuals within an organization, or requesting confirmation of additional or different information.

i. Where a specialist's work is particularly significant (see FAM 620 and AU-C 620), performing additional procedures related to some or all of the specialist's methods, assumptions, or findings to evaluate whether the findings are unreasonable, or engaging another specialist to do that.

[47]The FAM uses IDEA as an example of a computer software that the auditor can use to perform certain audit procedures. The auditor may use other software or tools as appropriate in the circumstances.

j. Performing additional or more focused tests of budget to actual variances and their underlying causes.

k. Performing targeted tests of the timing of cost/expense recognition.

l. Requesting that physical inventory counts be made on or closer to year-end.

m. If fraud risks relate to an interim period, performing audit tests that are focused on transactions that occurred in that interim period (or throughout the reporting period).

n. Testing a larger audit sample of disbursement transactions for validity.

o. Performing substantive analytical procedures that are more detailed by location, program, month, or other category (for example, analyzing specific credit lines in an allowance for loan losses, rather than the portfolio as a whole), or that use more precise techniques (for example, regression analysis).

p. Discussing with other auditors who are auditing the financial statements of one or more entity components the extent of work necessary to address fraud risks resulting from intragovernmental transactions and activity among those components.

Additional Examples of Auditor Responses to Fraud Risks Related to Fraudulent Financial Reporting

.03 The following paragraphs provide additional examples of auditor responses to fraud risks related to misstatements arising from fraudulent financial reporting in the areas of (1) accounting estimates, (2) revenue recognition, and (3) inventory quantities. These example responses involve the nature, extent, and timing of audit procedures.

Accounting Estimates

.04 Fraud risks may relate to management's development of accounting estimates. These risks may affect various accounts and assertions, such as valuation and completeness of liabilities related to insurance and credit programs, pensions, postretirement benefits, and environmental cleanup. These risks may also relate to significant changes in assumptions for recurring estimates. Further, because estimates are based on both subjective and objective factors, bias may exist in the subjective factors.

.05 Examples of procedures that the auditor may perform in response to fraud risks related to accounting estimates include the following:

a. Gathering additional information about the entity and its environment to assist in more extensively evaluating the reasonableness of accounting estimates and underlying judgments and assumptions, focusing on more sensitive or subjective aspects.

b. Performing a more extensive retrospective review of management judgments and assumptions applied in estimates made for prior periods. This could encompass analyzing each significant judgment and assumption in light of the events that occurred subsequently. The auditor may then identify (with management's assistance) reasons for any differences and whether these reasons apply to current period estimates.

c. Using the work of a specialist to evaluate an accounting estimate, or developing an independent estimate to compare to the accounting estimate.

Revenue Recognition

.06 Revenue recognition is affected by the particular facts and circumstances and sometimes—for example, for certain government corporations—by accounting principles that vary by type of operations. Hence, where revenue is (or is expected to be) material, the auditor should understand the criteria for revenue recognition that the entity uses and should design audit procedures based on the entity's operations and its environment, including the composition of revenue, specific attributes of the revenue transactions, and any other specific entity considerations.

.07 Examples of procedures that the auditor may perform in response to fraud risks related to improper revenue recognition include the following:

a. Performing substantive analytical procedures related to revenue that are based on more precisely developed expectations, such as comparing revenue between the current year and expectations by location, program, and month, or that establish the limit (see FAM 475.04–.05) at a lower percentage of tolerable misstatement. Audit techniques such as regression analysis may be helpful in performing these procedures.

b. Inquiring of entity personnel, including its general counsel, about any revenue-related transactions near the end of the reporting period and their knowledge of any unusual terms or conditions that may be related to those transactions.

c. Confirming with customers and other appropriate parties the relevant contract terms and the absence of side agreements that may influence the appropriate accounting.

d. Physically observing goods being shipped or readied for shipment (or returns awaiting processing) at one or more locations at the end of the reporting period and performing appropriate sales and inventory cutoff procedures.

e. Expanding tests of general and application controls related to revenue transactions that are electronically initiated, processed, and recorded.

Inventory Quantities

.08 Examples of procedures that the auditor may perform in response to fraud risks related to inventory quantities include the following:

a. Reviewing the entity's inventory records to identify locations, items, or issues that warrant attention during or after the physical inventory count. As a result of this review, the auditor may decide to observe inventory counts at some locations on an unannounced basis or to request that physical inventory counts be made at all locations on the same date on, or closer to, year-end.

b. Performing additional inventory inspection procedures, such as more rigorously examining the contents of boxed items; the manner in which the inventory is stacked (to identify hollow squares or other issues) or labeled; and—using the work of a specialist, if needed—the purity, grade, and concentration of inventory substances, such as specialty chemicals.

c. Performing additional tests of physical inventory count sheets or tags, and retaining copies of these documents to minimize the risk of subsequent alteration or inappropriate extension and summarization of the inventory.

d. Performing additional procedures focused on the quantities included in the priced inventory to further test the count quantities—such as comparing quantities for the current period with those for prior periods by inventory category, location, or other criteria, or comparing count quantities with perpetual records.

e. Using computer-assisted audit techniques to test the extension and summarization of the physical inventory counts—such as sorting by tag number to test tag controls or by item number to test for item omission or duplication—and to test for unusual quantities and cost amounts.

f. Establishing the limit (see FAM 475.04–.05) at a lower percentage of tolerable misstatement when performing substantive analytical procedures related to inventories.

Additional Examples of Auditor Responses to Fraud Risks Related to Misappropriation of Assets

.09 Additional examples of auditor responses to fraud risks related to misstatements arising from misappropriation of assets involving the nature, extent, and timing of audit procedures include the following:

a. Using information on improper payments, including information from entity review of programs and activities under PIIA, to develop and perform audit procedures focused on specific vulnerable areas.

b. Expanding the extent of participant-eligibility testing for benefit programs to encompass unannounced visits to intake centers or work sites to test the existence and identity of participants, to observe benefit payment distribution to identify “ghost” or deceased participants, or to use confirmation requests to test the existence of program participants. The auditor may also use data mining to search for duplicate payments; ineligible, ghost, or deceased participants; and other issues.

c. Obtaining a more comprehensive understanding of internal controls for assets that are highly susceptible to misappropriation, in order to identify relevant controls to prevent and detect a misappropriation; expanding the tests of those controls; and physically inspecting those assets at or near the end of the reporting period.

d. Assigning higher inherent risk to locations that have higher fraud risks (when, for example, large quantities of assets that are particularly susceptible to such risks are present), and modifying substantive procedures at those locations.

e. Establishing the limit (see FAM 475.04–.05) at a lower percentage of tolerable misstatement when performing substantive analytical procedures related to assets that are particularly susceptible to misappropriation.

295 J – Steps in Assessing Information System Controls

.01 As discussed in FAM 270, the following flowcharts illustrate steps the auditor and the IS controls auditor generally follow in understanding and assessing IS controls in a financial statement audit. However, the engagement team may decide to test the effectiveness of the general controls even if they are not likely to be effective (see fig. 1) or review application controls even though general controls are not effective (see fig. 2), in order to make recommendations on how to fix weak controls.

Figure 1: Steps in Assessing Information System (IS) Controls in a Financial Statement Audit

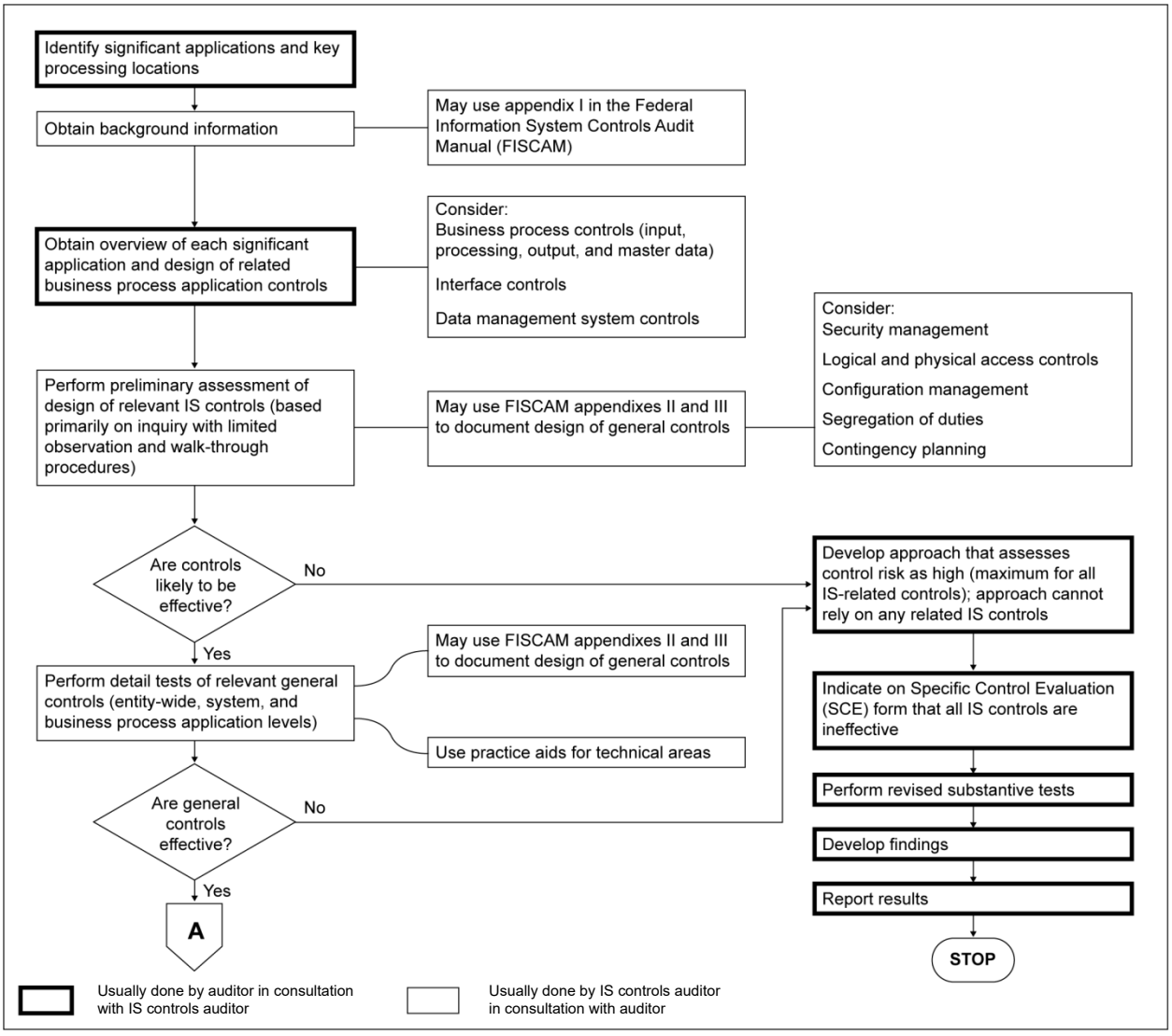
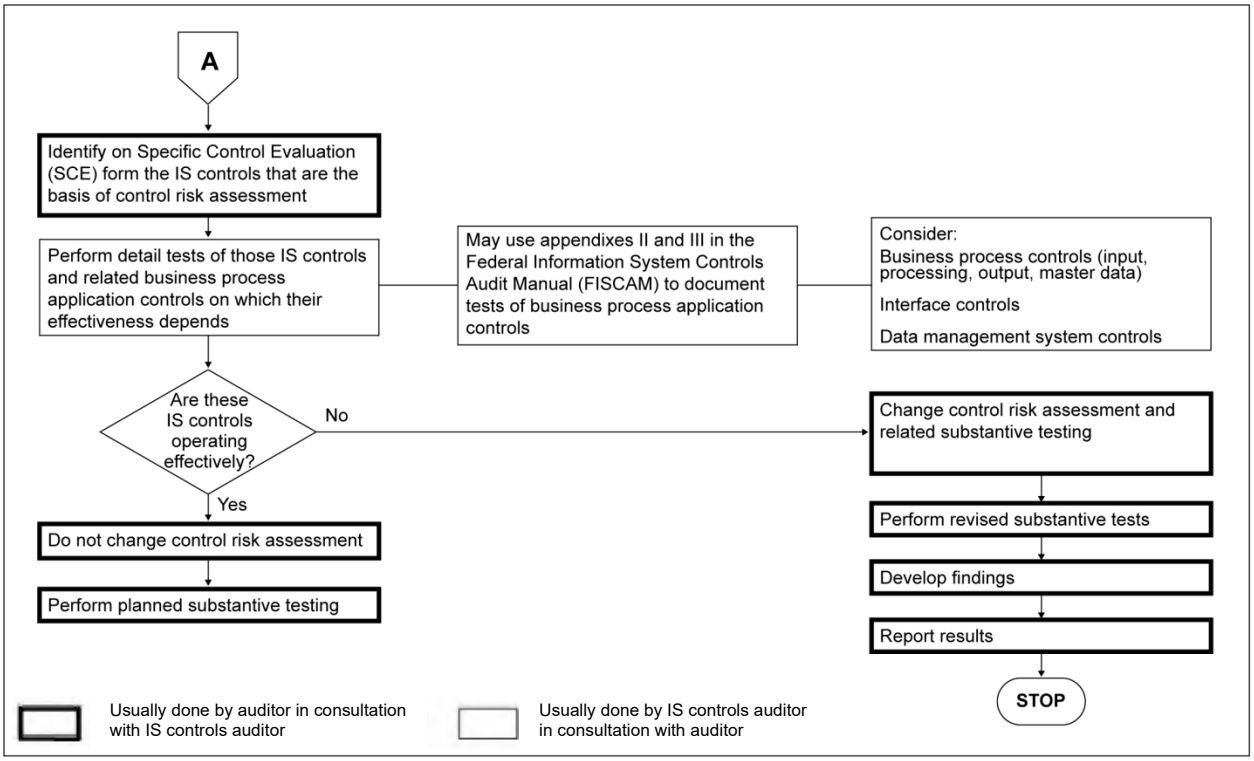


Figure 2: Steps for Each Significant Application in Assessing Information System (IS) Controls in a Financial Statement Audit



SECTION 300

Internal Control Phase

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310 – Overview of the Internal Control Phase

.01 In the internal control phase, the auditor continues the risk assessment procedures begun in the planning phase. The auditor expands the understanding of the entity's internal control gained during the planning phase and separately assesses control risk and the risk of material misstatement (i.e., combined assessment of inherent risk and control risk). The auditor performs and documents the following procedures:

- Understand the entity's design of the information systems for financial reporting; compliance with applicable provisions of laws, regulations, contracts, and grant agreements; and relevant operations (see FAM 320).
- Identify control objectives for each identified risk of material misstatement at the assertion level for which inherent risk is more than remote (see FAM 330).
- Identify and understand the design of control activities that are likely to achieve the control objectives, if implemented and operating effectively, for each identified risk of material misstatement at the assertion level for which inherent risk is more than remote (see FAM 340).
- Identify control activities the auditor plans to test (i.e., relevant control activities); determine whether relevant control activities have been implemented; and determine the nature, extent, and timing of tests of relevant control activities (see FAM 350).
- Determine the nature, extent, and timing of tests of compliance with the Federal Financial Management Improvement Act of 1996 (FFMIA) for CFO Act agencies (see FAM 350).
- Test the operating effectiveness of each relevant control activity that has been implemented and test entity-level controls related to the other four components of internal control (see FAM 360). Sampling control tests, if necessary, are performed in the testing phase and are discussed in FAM 450.
- Test compliance with FFMIA (see FAM 360).
- Assess, on a preliminary basis, (1) the effectiveness of financial reporting, compliance, and relevant operations controls; (2) control risk; and (3) the risk of material misstatement (see FAM 370).
- Consider partial-year controls and planned changes in controls (see FAM 380).

See FAM 390 for detailed documentation requirements.

.02 The auditor uses the results of internal control work to

- determine the nature, extent, and timing of further audit procedures (sampling control, compliance, and substantive testing discussed in FAM 400);
- update the evaluation of internal control as further evidence is obtained throughout the audit;

- determine any effects on the risk of material misstatement and the related sufficiency of other audit procedures (discussed in FAM 400 and 500); and
- obtain audit evidence for forming an opinion or reporting on internal control over financial reporting (discussed in FAM 500).

.03 The auditor may also use the results of internal control work in determining whether a population from which the auditor plans to select an audit sample is complete and valid. This may be appropriate in circumstances when the population is not reconcilable to an appropriate data source. Such internal control work may include testing the relevant general controls and application controls over the source of the population. See FAM 360 for guidance on testing IS controls and FAM 480 for guidance on performing substantive detail tests.

.04 According to Office of Management and Budget (OMB) audit guidance, for those controls that have been suitably designed and implemented, the auditor should perform sufficient tests of such controls to conclude whether the controls are operating effectively (i.e., sufficient tests of controls to support a low level of assessed control risk). Thus, the auditor should not elect to forgo control tests because it is more efficient to extend substantive and compliance audit procedures. If the auditor determined in a prior year that a control was not suitably designed or implemented, and if management indicates that the control has not improved, the auditor need not test it in the current year.

.05 Management, with oversight by those charged with governance or other oversight bodies, sets objectives to meet the entity's mission, strategic plan, and goals and requirements of applicable laws and regulations. Management groups objectives into one or more of the three categories of objectives: operations, reporting, and compliance.

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

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

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

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

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

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

.09 If the auditor's understanding is that the relevant control has been implemented, the auditor should test the following types of controls:

- **Financial reporting controls** (including certain **safeguarding** and **budget controls**) for each identified risk of material misstatement at the assertion level for which inherent risk is more than remote, for each material line item, account, note disclosure, and class of transactions (identified in FAM 235). In rare circumstances in which the auditor assessed all identified risks of material misstatement at remote for a material line item, account, note disclosure, or class of transactions, the auditor should perform control tests, as appropriate, if the auditor is providing an opinion on internal control.
- **Compliance controls** for each significant provision of applicable laws, regulations, contracts, and grant agreements identified for testing (see FAM 245), including **budget controls** for each relevant budget restriction (see FAM 250).
- **Operations controls** (1) for data relied on in performing financial audit

procedures or (2) selected for testing by the engagement team (see FAM 275).

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

.11 The auditor should obtain an understanding of how the entity uses the services of a **service organization** in the entity's operations for assessing risk and planning other audit procedures,[1] including the following (AU-C 402.09):

- the nature of the services provided by the service organization and the significance of those services to the entity, including their effect on the entity's internal control;
- the nature and materiality of the transactions processed or accounts or financial reporting processes effected by the service organization;
- the degree of interaction between the activities of the service organization and those of the entity; and
- the nature of the relationship between the entity and the service organization, including the relevant contractual terms for the activities undertaken by the service organization.

Based on AU-C 402.10, the auditor should determine whether relevant controls at the entity that relate to the services provided by the service organization, including those that are applied to the transactions processed by the service organization, have been implemented. If performing an audit of internal control over financial reporting, the auditor should consider the activities of the service organization when determining the evidence required to support the auditor's opinion on the effectiveness of the entity's internal control over financial reporting (AU-C 940.88).

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

See FAM 640 for additional requirements and guidance regarding service organizations.

[1]In this paragraph, "auditor" refers to the user auditor and "entity" refers to the user entity, as defined in AU-C 402, *Audit Considerations Relating to an Entity Using a Service Organization*. AU-C 402 defines (1) user entity as an entity that uses a service organization and whose financial statements are being audited and (2) user auditor as an auditor who audits and reports on the financial statements of a user entity.

.12 If the auditor is not providing an opinion on internal control, the auditor should evaluate whether the audit evidence is sufficient to achieve the audit objectives related to internal control described in OMB audit guidance.

If the auditor is not providing an opinion on internal control or is disclaiming an opinion on internal control, the auditor should evaluate whether the scope of the work is sufficient to meet the audit objective related to compliance with significant provisions of applicable laws, regulations, contracts, and grant agreements. If the scope is not sufficient, the auditor should report a scope limitation as discussed in FAM 580.97 through .98.

320 – Understand Information Systems

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

- processing and reporting of accounting, budget, compliance, and operations data and
- maintaining accountability for the related assets, liabilities, equity, and budgetary resources.[2]

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

The auditor should obtain sufficient knowledge of each type of system to understand the information reflected in FAM 320.03 through .07 in a manner that is appropriate to the entity's circumstances. This includes obtaining an understanding of how transactions originate within the entity's business processes, as discussed in AU-C 315.A154. It also includes understanding procedures for preparing financial statements and note disclosures (including year-end journal entries and reclassifications) and understanding how misstatements may occur. The auditor should identify the points within the entity's processes at which a misstatement, including a misstatement due to fraud, could arise that individually or in combination with other misstatements, would be material (for example, points at which information is initiated, transferred, or otherwise modified) (AU-C 940.29b).

If the auditor has determined that a service organization maintains any of the significant financial management systems, then the auditor should follow the guidance outlined in FAM 640.

Because of the technical nature of many IS controls, the auditor generally should obtain assistance from an IS controls auditor in understanding the entity's use of information system processing (i.e., processing performed by information systems using information technology) and in planning, directing, or performing audit procedures related to assessing IS controls. Additionally, an information technology specialist may assist the auditor in understanding technical aspects of information system processing and IS controls. The auditor may also coordinate with or leverage work of the Federal Information Security Modernization Act of 2014 auditor or evaluator in understanding entity's IS controls environment. The auditor should document the understanding of the information system processing and IS controls in cycle memorandums, or other equivalent narratives, and may prepare or obtain related flowcharts. FAM 340 and 350 discuss identifying and

[2]As indicated in FAM 260, the Federal Managers' Financial Integrity Act report and its supporting documentation may be used as a starting point for understanding and evaluating internal control. The auditor may use management's documentation of systems and internal control, including OMB Circular No. A-123 work, where appropriate. The auditor may use management's tests of controls as part of the auditor's tests of controls if such tests were executed by competent individuals independent of the controls. (See FAM 640 and FAM 645 for further information.)

documenting controls that achieve control objectives.

Walk-throughs of Information Systems

.02 The auditor generally should perform sufficient system walk-throughs to confirm the understanding of significant information about such systems and discuss any system changes with management. FAM 350.08 discusses walk-throughs to confirm the auditor's understanding of controls. In a walk-through of a financial management system, the auditor traces one or more transactions from initiation through all processing to inclusion in the general ledger, observing the processing in operation, making inquiries of entity staff, and inspecting related documents.

Walk-throughs are important for understanding the transaction process and for determining appropriate audit procedures. The auditor should perform walk-throughs for all material line items, accounts, note disclosures, and classes of transactions. Walk-throughs of financial management, budget, compliance, and operations systems provide evidence about the functioning of such systems. The auditor should document these walk-throughs. The auditor should incorporate the information technology aspects of each system into the audit documentation and may include additional flowcharts, narratives, and checklists.

Financial Management Systems

.03 For each material line item, account, note disclosure, and class of transactions identified in FAM 235, the auditor should obtain an understanding of and should document the design of

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

include

- procedures used to enter transaction totals into the general ledger;
- procedures related to the selection and application of accounting policies;
- procedures used to initiate, authorize, record, and process journal entries in the general ledger;
- procedures used to record recurring and nonrecurring adjustments to the financial statements;
- procedures for preparing financial statements (AU-C 940.24); and
- procedures used to combine and consolidate general ledger data.

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

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

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

Budget Systems

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

- developing and requesting apportionments from OMB;
- establishing and allocating allotments within the entity, including reprogramming of allotments;
- establishing and recording commitments, if applicable;
- establishing, recording, and monitoring obligations (such as undelivered orders, which include contracts and purchase orders);
- establishing and recording expended authority (delivered orders);

- establishing and recording outlays;
- monitoring supplemental appropriations;
- recording deobligations when the entity has made a formal decision to cancel or reduce an obligation, supported by any necessary documentation that has been fully executed (e.g., SF-30 for contract amendments).
- recording transactions in and adjustments to expired accounts; and
- monitoring canceled (closed) accounts.

Compliance Systems

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

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

Operations Systems

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

330 – Identify Control Objectives

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

- **Financial reporting controls** to prevent, or detect and correct, misstatements in the financial statements. These include **safeguarding controls** to safeguard assets against loss from unauthorized acquisition, use, or disposition and **segregation-of-duties controls** to prevent one person from controlling multiple aspects of a transaction, allowing that person to both cause and conceal misstatements whether due to error or fraud.
- **Budget controls** to provide reasonable assurance that the entity (1) properly records, processes, and summarizes transactions to permit the preparation of the statement of budgetary resources and reconciliation of net cost to net outlays[3] in accordance with U.S. GAAP and (2) executes transactions in accordance with budget authority.
- **Compliance controls** to comply with significant provisions of applicable laws, regulations, contracts, and grant agreements.
- **Operations controls** to achieve the performance desired by management for planning, productivity, quality, economy, efficiency, or effectiveness of the entity's operations.

This section describes the process for identifying control objectives.

Financial Reporting Controls

.02 The auditor should test relevant **financial reporting controls** for each material line item, account, note disclosure, and class of transactions (see FAM 235), if the auditor has determined that controls have been implemented. The first step in identifying control objectives for financial reporting controls is to consider the identified risks of material misstatement at the assertion level for which inherent risk is more than remote for each material line item, account, note disclosure, and class of transactions. The auditor may identify multiple types of potential misstatements in an assertion. Some types of potential misstatements may affect only a portion or component of a line item, account, note disclosure, or class of transactions (see FAM 265). For example, for the existence or occurrence assertion, risks of material misstatement might be identified in four areas.

- **Occurrence/validity:** Recorded transactions and events did not actually

[3]Per OMB reporting guidance, the reconciliation of net cost to net outlays may be presented as a financial statement or note to the financial statements.

occur or do not pertain to the entity.

- **Cutoff:** Transactions and events are recorded in the current period, but occurred in a different period.
- **Summarization:** Transactions are summarized improperly, resulting in an overstated total.
- **Existence:** Recorded assets, liabilities, net position, and budgetary balances do not exist at a given date. Projected revenues or expenditures in the sustainability financial statements are not valid.

For each identified risk of material misstatement at the assertion level for which inherent risk is more than remote, there is one or more control objectives that, if achieved, would prevent, or detect and correct, the potential misstatement. These control objectives provide the auditor with the primary basis for assessing the effectiveness of an entity's control activities. See FAM 395 B for a list of potential misstatements that could occur in each assertion and the related control objectives.

.03 As discussed in FAM 235, the auditor identifies the material classes of transactions that provide input for or support each material line item, account, and note disclosure. Classes of transactions are classified as (1) transaction related or (2) line item/account related.

- Transaction-related classes of transactions are the activities and events that occur during the period under audit and result in debit and credit entries to the entity's accounts (e.g., billing, purchasing, cash receipts, cash disbursements, journal vouchers, and adjusting entries). Transactions within each class are generally subject to similar risks and internal controls. These classes of transactions generally affect line items reported on all financial statements.
- Line item/account-related classes of transactions are the activities that support balances that exist at period-end (e.g., cash balance, property balance, and accounts payable balance). These classes of transactions generally affect line items reported on the balance sheet or ending balances reported on the statement of budgetary resources.

For example, when cash is received, the entity typically debits cash and credits revenue or accounts receivable. At period-end, the entity will typically also perform reconciliations and other activities to support the ending cash balance. As illustrated in FAM 395 A, classes of transactions that affect the cash line item typically include the cash receipts, cash disbursements, and cash balance, while classes of transactions that affect the revenue line item typically include billing and cash receipts.

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

(1) the existence assertion for the cash account and (2) the completeness assertion for accounts receivable or the occurrence assertion for revenue.

.05 To understand the effect of misstatements on those line items and accounts that reflect balances at period-end (i.e., period-end balances), such as asset, liability, net position, or ending budgetary balances, the auditor should consider both transaction-related and line item/account-related assertions. The auditor may consult table 330.1 regarding how transaction-related assertions may affect line item/account-related assertions.

Table 330.1: Effect of Transaction-Related Assertions on Line Item/ Account-Related Assertions for Period-End Balances

Transaction-related assertions	Line item/account-related assertions affected
Occurrence/validity	• Existence, if the transaction increases the line item/account balance • Account completeness, if the transaction decreases the line item/account balance
Transaction completeness	• Account completeness, if the transaction increases the line item/account balance • Existence, if the transaction decreases the line item/account balance
Accuracy	• Accuracy, valuation, and allocation, if the transaction increases/decreases the line item/account balance

.06 FAM 395 B includes a list of potential misstatements that could occur in each assertion and the related control objectives. As discussed in FAM 265, the auditor tailors the potential misstatements included in FAM 395 B to the specific circumstances of the entity. These potential misstatements represent identified risks of material misstatement at the assertion level for material line items, accounts, note disclosures, and classes of transactions. For each identified risk of material misstatement at the assertion level for which inherent risk is more than remote, the auditor should identify the control objectives (and ultimately related control activities) that could prevent, or detect and correct, the potential misstatement. The auditor should tailor the list of control objectives in FAM 395 B, as appropriate, which may include supplementing the list with additional objectives or subobjectives.

.07 The auditor should prepare specific control evaluation (SCE) worksheets or equivalent documentation that collectively documents, for material line items, accounts, note disclosures, and classes of transactions,

- the identified risks of material misstatement at the assertion level and
- the control objectives and control activities that address those risks for which inherent risk is more than remote.

The auditor should also link each SCE worksheet to the related LIRA form(s) where the assessment of inherent risk, control risk, and risk of material misstatement is documented. See FAM 395 G and 395 H for instructions on preparing an SCE worksheet and LIRA form, respectively. Sample forms for preparing the LIRA form and SCE worksheet electronically are available at https://www.gao.gov/financial_audit_manual (accessed June 3, 2024).

Safeguarding Controls

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

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

The auditor should test safeguarding controls related to segregation of duties controls as discussed in FAM 360.09 through .10.

Budget Controls

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

Compliance Controls

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

Operations Controls

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

The auditor should test operations controls relied on in performing financial audit procedures, and any others selected for testing by the engagement team, if any. See FAM 275.08 and FAM 495 A.20 through .22 for examples of the auditor using entity-prepared reports for substantive tests, such as substantive analytical procedures, and discussions of tests of related controls over the report data, such as operations controls.

340 – Identify and Understand Control Activities

.01 As discussed in FAM 330, for each identified risk of material misstatement at the assertion level for which inherent risk is more than remote, the auditor should identify the control objectives that could prevent, or detect and correct, the potential misstatement. For each control objective identified, based on discussions with entity personnel and the results of other procedures performed, the auditor should identify the control activities that, if effectively designed, implemented, and operating, would allow management to achieve the control objective. These control activities include

- controls in the control environment, entity risk assessment, information and communication, and monitoring components that directly address the risks of material misstatement at the assertion level (see FAM 360.19) and
- those that are designed and implemented by a service organization used by the entity (see FAM 640).

.02 The auditor should determine whether the control activities identified depend on information system processing. A dependency on information system processing exists if a control activity cannot reasonably be expected to achieve a specific control objective without effective information system processing—either in the performance of the control activity or in the production of information used in the performance of the control activity. Because of the technical nature of many IS controls, the auditor generally should obtain assistance from an IS controls auditor in understanding the entity's use of information system processing and in planning, directing, or performing audit procedures related to assessing IS controls. For example, an IS controls auditor may assist the auditor in identifying and understanding the design of application controls and general controls implemented at the entity-wide, system, and application levels that help ensure the effective operation of the control activities that depend on information system processing. Additionally, an information technology specialist may assist the auditor in understanding technical aspects of information system processing and IS controls.

.03 Based on AU-C 315.30a, the auditor should obtain a sufficient understanding of the design of control activities to determine whether they are likely to achieve the control objectives (i.e., effectively designed to address the risk of material misstatement at the assertion level or effectively designed to support the operation of other control activities), assuming an effective control environment, entity risk assessment, information and communication, monitoring, appropriate segregation of duties, and effective general controls. The purpose of this assumption is for the auditor to identify any deficiencies in the specific control activities of the entity that the auditor should report, as discussed in FAM 580, and recommend that the entity correct. Often only multiple control activities, together with other components of internal control (control environment, entity risk assessment, information and communication, and monitoring), will be sufficient to address a risk.

.04 For accounting estimates, the auditor should identify and obtain an understanding of control activities related to

a. management's process for making accounting estimates (AU-C 540.12i) and

b. how management reviews the outcomes of previous accounting estimates and responds to the results of that review (AU-C 540.12j).

.05 For relationships and transactions with disclosure entities, related parties, and public-private partnerships, the auditor should identify and obtain an understanding of control activities, if any, established to

a. identify, account for, and disclose the relationships and transactions with disclosure entities, related parties, and public-private partnerships;

b. authorize and approve significant transactions and arrangements with disclosure entities, related parties, and public-private partnerships; and

c. authorize and approve significant unusual transactions and arrangements outside the normal course of business (AU-C 550.15).

As part of understanding the controls, the auditor should inquire about any transactions with disclosure entities, related parties, and public-private partnerships

- that have not been authorized and approved in accordance with the entity's established policies or procedures regarding the authorization and approval of such transactions and
- for which exceptions to the entity's established policies or procedures were granted and the reasons for granting those exceptions (AU-C 550.15).

.06 Based on AU-C 315.27, the auditor should identify and obtain an understanding of

a. control activities over journal entries and other adjustments that address the risk of management override of controls (see FAM 265.54a);

b. control activities that address a risk that is determined to be a significant risk (see Identify and Respond to Significant Risks section in FAM 265); and

c. other control activities that based on the auditor's professional judgment the auditor considers are appropriate to enable the auditor to assess the risks of material misstatement at the assertion level and to design further audit procedures. These may include control activities related to reconciling detailed records to the general ledger and complementary user entity controls, if the entity uses a service organization (AU-C 315.A187).

.07 Based on the control activities identified in FAM 340.06, the auditor should identify aspects of the entity's information technology environment that are subject to risks arising from the use of information technology (AU-C 315.28). For these aspects, the auditor should identify the

a. related risks arising from the use of information technology and

b. entity's general controls that address such risks (AU-C 315.29).

See Effect of Information Technology on Internal Control section in FAM 260 and Test IS Controls section in FAM 360 for further guidance.

Factors to Consider

.08 When evaluating whether control activities are likely to achieve the control objectives, the factors that the auditor should consider include directness, selectivity, manner of application, and follow-up. In determining whether control

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

.09 **Directness** refers to the extent to which a control activity relates to a control objective. The more direct the relationship, the more effective that activity may be in achieving the objective. For example, management reviews of inventory reports that summarize the inventory by storage facility may be less effective in preventing, or detecting and correcting, misstatements in the existence assertion for inventory than a periodic physical inventory, which is more directly related to the existence assertion.

.10 **Selectivity** refers to the magnitude of the amount, or the significance of other criteria or distinguishing characteristics, that a specific control activity will identify as an exception condition. Examples of selectivity thresholds are (1) a requirement for additional approvals of all payments to vendors in excess of $25,000 and (2) management reviews of all payments to vendors not on an entity's approved vendor list. When determining whether a control activity is likely to be effective, the auditor should evaluate the likelihood that items that do not meet the selectivity threshold could, in the aggregate, result in material misstatements of financial statements; material noncompliance with budget authority; material noncompliance with significant provisions of applicable laws, regulations, contracts, and grant agreements; or significant ineffective or inefficient use of resources.

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

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

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

.12 **Follow-up** refers to the procedures performed when a control activity identifies an exception condition. A control activity's effectiveness depends on the effectiveness of follow-up procedures. To be effective, an entity needs to (1)

apply these procedures on a timely basis, (2) determine whether control exceptions represent misstatements, and (3) correct all misstatements noted. For example, as a control, a financial management system may identify and put exception transactions into a suspense file or account. Lack of timely follow-up procedures by the entity to (1) reconcile and review the suspense file or account and (2) correct items in the suspense file or account would render the control ineffective.

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

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

.01 For each control objective, the auditor should

- identify control activities to test (i.e., relevant control activities) (FAM 350.04–.07);[4]
- perform walk-throughs to determine whether relevant control activities have been implemented (FAM 350.08–.10);
- document relevant control activities in the SCE worksheet or equivalent (FAM 350.11); and
- determine the nature, extent, and timing of tests of relevant control activities (FAM 350.13–.26).

.02 As noted in FAM 310, according to OMB audit guidance, for those controls that have been suitably designed and implemented, the auditor should perform sufficient tests of such controls to conclude whether the controls are operating effectively (i.e., sufficient tests of controls to support a low level of assessed control risk). Thus, the auditor should not elect to forgo control tests because it is more efficient to extend substantive and compliance audit procedures.

.03 For CFO Act agencies, the auditor also should determine the nature, extent, and timing of tests for determining whether the entity's financial management systems are in substantial compliance with federal financial management systems requirements (these requirements are established by the Department of the Treasury and published in the *Treasury Financial Manual* (TFM), volume 1, chapter 9500); federal accounting standards (U.S. GAAP—see FAM 560); and the USSGL at the transaction level in order to report in accordance with FFMIA (FAM 350.27–.30).

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

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

[4]"Relevant control activities" as used in the FAM are referred to as identified controls or controls that address the risks of material misstatement at the assertion level in AU-C 315. FAM 395 C presents a list of typical control activities that an entity may establish to help prevent, or detect and correct, misstatements in assertions.

FFMIA requirements.

Identify Relevant Control Activities

.04 As discussed in FAM 340, the auditor identifies and obtains an understanding of the design of control activities for each control objective identified in FAM 330. Using this understanding, the auditor should determine which control activity, or combination of control activities, to test (i.e., relevant control activities) based on their ability to (1) achieve the control objective and (2) improve the efficiency of control tests. For example, the auditor may have identified several control activities that are equally effective in achieving a control objective. In such a case, the auditor generally should test only those control activities that are necessary to achieve the control objective and are efficient to test, considering such factors as

- the extent to which a control activity achieves several control objectives and thereby reduces the number of control activities that would ordinarily need to be tested;
- the time that will be required to test the control activity; and
- control dependencies, particularly for IS controls (see FAM 340.02).

The auditor may, based on risk, test different control activities from year to year in a recurring audit, but it does not change the auditor's responsibility to test the control activity, or combination of control activities, in the current-year audit that is necessary to achieve the control objective. See FAM 360 and 450 for guidance on performing tests of control activities.

.05 In identifying relevant control activities, the auditor should consider

- the assessment of inherent risk and
- the tentative determination of the likelihood that IS controls will be effective (see FAM 270).

For example, assertions that have high inherent risk normally require stronger or more extensive controls to prevent, or detect and correct, material misstatements than assertions with low inherent risk.

.06 If a control activity is not effectively designed or not likely to operate effectively (based on prior years' control tests and the auditor's understanding of the control activity in the current year, including management's indication that controls have not improved from the prior year), the auditor does not need to test the operating effectiveness of that control activity in the current year.

If, during any phase of the audit, the auditor determines that a relevant control activity is, in fact, ineffective in design, implementation, or operation in achieving the control objective, the auditor may discontinue testing that control activity and should report the identified deficiencies in internal control, as discussed in FAM 580. The auditor should determine whether one or more other control activities are likely to achieve the same objective, and if so, the auditor should test them and update the SCE worksheet accordingly.

.07 In addition to identifying relevant control activities, the auditor should identify and test those entity-level controls that are important to the auditor's conclusion about

whether the entity has effective internal control over financial reporting (AU-C 940.22). Testing of entity-level controls as it relates to the other four components of internal control (control environment, entity risk assessment, information and communication, and monitoring) is discussed in FAM 360.19. Per AU-C 940.A35, the auditor's evaluation of entity-level controls can result in increasing or decreasing the testing that the auditor otherwise would have performed on other controls.

Perform Walk-throughs to Determine Whether Relevant Control Activities Have Been Implemented

.08 The auditor should perform one or more walk-throughs of each relevant control activity identified to determine whether the control activity is functioning in the manner understood by the auditor. These walk-throughs are performed to determine whether relevant control activities have been implemented and differ from those performed to confirm the auditor's understanding of the information systems (see FAM 320.02). These walk-throughs include a mix of observation, inspection, and inquiry with personnel responsible for applying or maintaining each control activity (see FAM 350.14–.16).

.09 Based on AU-C 315.30b, through these walk-throughs and the system walk-throughs discussed in FAM 320.02, the auditor should determine whether each relevant control activity has, in fact, been implemented. If a relevant control activity has not been implemented, the auditor should consider whether one or more other control activities are likely to achieve the same objective, and if so, the auditor should determine whether such control activity has been implemented. If such other control activities have been implemented, the auditor should update the SCE worksheet accordingly.

.10 In obtaining evidence about whether relevant control activities have been implemented, the auditor should determine whether the entity is using them rather than merely having them written in a manual. This differs from determining operating effectiveness, which is concerned with how the control activity was applied; the consistency with which it was applied; and by whom and by what means it was applied, including, when applicable, whether the person performing the control activity has the necessary authority and competence to perform it effectively.

Document Relevant Control Activities

.11 The auditor should document relevant control activities and whether they have been implemented in the SCE worksheet or equivalent (see FAM 395 G).[5] The auditor may list (and evaluate) control activities that satisfy more than one control objective only once and refer to these control activities, when applicable, on subsequent occasions. For each relevant control activity, the auditor should determine whether it is an IS control, as discussed in FAM 270 and FAM 295 F. The auditor generally should obtain concurrence from an IS controls auditor on

[5]In the FAM, control activities include controls within the control environment, entity risk assessment, information and communication, and monitoring components that directly address risks of material misstatement at the assertion level (see FAM 360.19).

the auditor's identification of IS controls. See FAM 390.02 for documentation requirements related to all five components of internal control.

.12 Before testing relevant control activities, the auditor may tentatively complete the LIRA form or equivalent, assuming that they are effective.

Determine the Nature of Control Tests

.13 To obtain sufficient, appropriate evidence about the effectiveness of relevant control activities as well as the other components of internal control (see FAM 360.19), the auditor should determine the combination of control tests (**observation, inquiry,** or **inspection**) to be performed. No one specific control test is always necessary, applicable, or equally effective in every circumstance. In designing and performing tests of controls, the auditor should do the following:

a. Perform other audit procedures in combination with inquiry to obtain sufficient appropriate audit evidence about the operating effectiveness of controls, including

- how the controls were applied at relevant times during the period under audit;
- the consistency with which they were applied; and
- by whom or by what means they were applied, including, when applicable, whether the person performing the control possesses the necessary authority and competence to perform the control effectively (AU-C 330.10a).

b. To the extent not already addressed, determine whether the controls to be tested depend on other controls and, if so, whether it is necessary to obtain audit evidence supporting the operating effectiveness of those controls (AU-C 330.10b).

   For example, the auditor may have identified relevant control activities that depend on information system processing. As discussed in FAM 270, such control activities are often application and user controls. The auditor should identify and test the general controls that help to ensure the effective operation of application and user controls. See FAM 360 for guidance on testing general, application, and user controls.

See FAM 340 for the factors to consider when evaluating whether controls are likely to achieve the control objective. In determining the types of tests to apply, the auditor should determine the tests that are effective and efficient. Specific types of control tests and methods to apply them are discussed in the following paragraphs.

.14 **Observation.** The auditor conducts observation tests, which include looking at a process or procedure being performed by others (for example, the auditor's observation of inventory counting by the entity's personnel or the performance of control activities) (AU-C 500.A52). Observation generally provides highly reliable evidence that a control activity is properly applied when the auditor is there to observe it. However, it provides no evidence that the control was in operation at any other time. Consequently, the auditor generally should supplement observation tests with corroborative evidence obtained from other tests (such as **inquiry** and **inspection**) about the operation of controls at other times.

.15 **Inquiry.** The auditor conducts inquiry tests by seeking information, both financial and nonfinancial, from knowledgeable persons within the entity or outside the entity (AU-C 500.A62). The auditor makes either oral or written inquiries of entity personnel involved in the application of specific control activities to determine what they do or how they perform a specific control activity. Such inquiries are typically open ended. Evidence obtained from inquiry alone is not sufficient. Thus, the auditor should supplement inquiry with other types of control tests—**observation** or **inspection** (which may include reperformance). Combining inquiry with inspection typically provides more assurance than inquiry combined only with observation. The reliability of evidence obtained from inquiry depends on various factors, including the following:

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

.16 **Inspection.** The auditor conducts inspection tests by examining an asset (either by being physically present or using remote observation tools) or examining records or documents, whether internal or external or in paper form, electronic form, or other media (AU-C 500.A51), for evidence (such as the existence of initials or signatures) that a control activity was applied. System documentation, such as operations manuals, flowcharts, and job descriptions, may provide evidence of control design but do not provide evidence that controls are implemented and operating effectively. To use system documentation as part of the evidence of effective control activities, the auditor should obtain additional evidence on how the controls were applied.

Inspection is generally a reliable source of audit evidence, and because evidence of performance is documented, this type of test can be performed at any time. However, since documentary evidence generally does not provide evidence concerning how effectively the control was applied, the auditor generally should supplement inspection tests with observation or inquiry of persons applying the control. For example, the auditor generally should supplement inspection of initials on documents with observation, inquiry, or both of the individual(s) who initialed the documents to understand the procedures they followed before initialing the documents. The auditor may also reperform the control being tested to determine if it was properly applied.

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

.18 The **nature of the control** influences the type of evidence that is available. For example, if the control provides documentary evidence, the auditor may inspect the documentation. For other controls, documentation may not be available or

relevant. In these circumstances, the auditor may obtain evidence about the effectiveness of the control's operation through (1) direct observation of the control being applied during the audit period, (2) inquiry of the individual(s) involved about applying the control at other times during the audit period, and (3) review of entity policies and procedures.

.19 The **timing of the control test and the period covered** by the control influence the control test. The auditor should obtain evidence relating to the audit period. Unless it is documentary evidence, the auditor generally should obtain the evidence during the audit period, when sufficient corroborative evidence is most likely to be available. When the evidence relates to only a specific point in time, such as evidence obtained from observation, the auditor should obtain additional evidence that the control activity was effective during the entire audit period. For example, the auditor may observe the control in operation during the audit period and use inquiry and inspection of procedures manuals to determine that the control was in operation during the entire audit period. FAM 380.01 provides guidance concerning situations when new controls are implemented during the year. If the auditor tests controls after the audit period, the auditor should determine if any changes occurred between the end of the audit period and the time of the test. See FAM 350.25 and .26 for further discussion of interim testing of controls.

.20 When selecting a particular control test from among equally effective tests, the auditor should select the most efficient test. When statistical sampling is considered necessary, the auditor should consider performing multipurpose testing to enhance audit efficiency (see FAM 430 and FAM 450).

Determine the Extent of Control Tests

.21 For each relevant control activity that has been implemented, the auditor should test the control activity to determine whether it is operating effectively to achieve the control objectives. Relevant financial reporting, budget, compliance, and operations controls generally should be tested to the same level of assurance.

.22 After determining the nature of control tests to be performed, the auditor should determine the extent of control tests (including IS controls). This determination is based on the

- information gathered in developing an understanding of internal control (including the nature of the control, the nature and availability of evidence, and how frequently the control is performed),
- extent to which audit evidence is obtained from tests of other controls, and
- auditor's determination of the amount of additional evidence needed.

As the planned level of assurance increases, the auditor should seek more reliable or more extensive audit evidence. The extent of testing is also discussed in FAM 360 and FAM 450.

.23 As discussed in FAM 350.18, for controls that do not leave documentary evidence of existence or application, the auditor may test their effectiveness by observation, inquiry, or both. However, the appropriate extent of observation and inquiry is not readily quantifiable and is therefore a matter of the auditor's judgment.

.24 Testing the operating effectiveness of controls is different from obtaining an understanding of and evaluating the design and implementation of controls. However, the same types of audit procedures are used. The auditor may therefore decide it is efficient to test the operating effectiveness of controls at the same time the auditor is evaluating their design and implementation (AU-C 330.A22), such as while performing walk-throughs as discussed in FAM 320.02 and 350.08.

Further, although some risk assessment procedures may not have been specifically designed as tests of controls, they may nevertheless provide audit evidence about the operating effectiveness of the controls and consequently serve as tests of controls. For example, the auditor's risk assessment procedures may have included inquiries about management's use of budgets, observing management's comparison of monthly budgeted and actual expenses, and inspecting reports pertaining to the investigation of variances between budgeted and actual amounts (AU-C 330.A23).

Determine the Timing of Control Tests

.25 The auditor should determine when to perform control tests. For efficiency, the auditor may perform most control testing on an interim basis that covers 9 or 10 months of the audit period and perform a roll-forward and limited testing for the remaining audit period. The auditor should obtain evidence about significant changes to those controls subsequent to the interim period and determine the additional audit evidence to be obtained for the remaining period (AU-C 330.12). If the auditor is providing an opinion on internal control, the auditor should determine the additional evidence needed concerning the operation of the controls as of the end of the year (see FAM 495 C for additional guidance).

.26 Another approach is for the auditor to determine the actual population of transactions for the audit period through an interim date and estimate the transactions for the remaining audit period. A statistical sample can then be drawn that covers the entire audit period, with the bulk of testing completed during the interim period and the remaining items tested immediately after year-end. The auditor generally should overestimate the remaining items in the population so every item will have a chance of selection. An underestimate by the auditor would leave some items out of the population subject to audit sampling, although they may be tested in other ways.

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

.27 For CFO Act agencies, which are subject to FFMIA, the auditor determines whether agency financial management systems comply substantially with the three FFMIA requirements. The auditor should plan and perform audit work in sufficient detail to enable the auditor to determine the degree to which agency financial management systems comply with the FFMIA requirements and whether that degree of compliance is substantial. See FAM 701 for further guidance on determining substantial compliance with FFMIA.

.28 Because of the overlapping scope and nature of FFMIA assessments and financial statement audits, the auditor may use the work performed as part of the financial statement audit in determining substantial compliance with FFMIA.

Specifically, many control and substantive tests performed in a financial statement audit may also provide evidence regarding compliance with FFMIA and generally should be performed concurrently (multipurpose testing).

.29 The auditor may limit the scope of work performed to support the FFMIA assessment with respect to those requirements for which there is sufficient evidence that the systems do not comply substantially with FFMIA (e.g., continuation of previously reported lack of substantial compliance with FFMIA).

.30 When limiting the scope of work performed, the auditor may obtain sufficient information to describe instances of lack of substantial compliance and make recommendations of remedial actions, as required by FFMIA, by (1) gaining an understanding of the design of the systems and controls, (2) performing control and substantive testing as part of the financial statement audit, and (3) reading management-developed documentation about systems' compliance with FFMIA. However, if the auditor is concerned that it may be difficult to convince management of the systems' lack of substantial compliance without specific tests, the auditor generally should perform the testing needed for this purpose.

360 – Perform Tests of Controls and Compliance with FFMIA

.01 The auditor should test the operating effectiveness of relevant control activities that have been implemented (FAM 360.06–.18). As part of testing control activities, the auditor should also test segregation-of-duties (FAM 360.09–.10) and IS controls (FAM 360.11–.18).

.02 The auditor should test the operating effectiveness of controls related to the remaining components of internal control—control environment, entity risk assessment, information and communication, and monitoring—to support the auditor's assessment of the effectiveness of internal control over financial reporting (FAM 360.19).

.03 The auditor should evaluate the results of control tests performed through the internal control phase (FAM 360.20–.22).

.04 Based on the results of control tests performed through the internal control phase and the results of sampling control tests in the testing phase (see FAM 450), the auditor should evaluate the effectiveness of the entity's internal control over financial reporting (FAM 360.23).

.05 For CFO Act agencies, the auditor should design and conduct tests of the financial management systems' substantial compliance with the three FFMIA requirements, if the auditor determines that such tests are necessary (see FAM 350.03 and 350.27–.30). After testing, the auditor may make a preliminary conclusion as to whether the entity's financial management systems comply substantially with the three FFMIA requirements (see FAM 360.24).

Perform Tests of Controls

.06 When planning control tests, the auditor should select sufficient items for control testing to support a low level of assessed control risk. For controls that do not operate frequently, such as those that operate only once or twice a year (e.g., controls over the year-end closing process), the auditor may determine that it is necessary to test all the items in the population (i.e., all occurrences of the control performance during the audit period). If the auditor does not plan to test all of the items in the population, the auditor generally should use one of two methods to select items for control testing: (1) statistical sampling (intended to be representative of and projected to the population) or (2) nonstatistical selection (not representative of and not projectable to the population).[6] Control tests that involve nonstatistical selection are discussed below and sampling control tests are discussed in FAM 450.

Control Tests That Involve Nonstatistical Selection

.07 Performing control tests that involve nonstatistical selection may provide sufficient evidence, along with other sources of evidence, that a control is operating effectively during the year and may be the most efficient way to test. For example, some controls may operate biweekly or weekly, such as controls over payroll processing that operate 26 or 52 times a year. For these controls,

[6]Nonstatistical sampling is generally not used in tests of controls.

statistical sampling may not be efficient or even feasible given the small number of items in the population from which to select the sample. For these less frequently operating controls, the effect of other sources of evidence is often greater than it is for controls that operate more frequently.

Table 360.1 provides guidance on the number of items to select when testing small populations associated with less frequently operating controls (see AICPA's audit guide, *Audit Sampling*). For larger populations, such as controls that operate daily, the auditor generally should perform statistical sampling to obtain evidence of control effectiveness (see FAM 430 and 450).

Table 360.1: Testing Small Populations

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

.08 In nonstatistical selection, the auditor selects items for control testing based on the auditor's judgment. The auditor can test the selected items using any type of test or combination of tests (i.e., observation, inquiry, inspection, or a combination of these, although inquiry alone is not sufficient). For example, the auditor may determine that inquiries of entity personnel regarding the specific procedures performed in a control and inspection of documents evidencing performance of those procedures together provide sufficient evidence of the control's operating effectiveness.

Test Segregation-of-Duties Controls

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

.10 The auditor should test and document segregation-of-duties controls and may use the following procedures as appropriate:

a. Identify the assets to be controlled through the segregation of duties.

b. Identify the individuals who have authorized access (direct or indirect) to the assets. An individual with direct access is authorized to handle the assets directly (such as during the processing of cash receipts). An individual with indirect access is authorized to prepare documents that cause the release or transfer of assets (such as preparing the necessary forms to request a cash disbursement or transfer of inventory).

c. For each individual with authorized access to assets, determine whether there are sufficient asset access controls. Asset access controls are those controls that are designed to provide assurance that actions taken by

individuals with authorized access to assets are reviewed and approved by other individuals. For example, an approval of an invoice for payment generally provides asset access controls (relating to cash) over those individuals authorized to prepare supporting documentation for the transaction. If information systems provide access to assets, the auditor should design tests of IS controls to identify (1) individuals (including information systems personnel) who may use the computer to obtain access and (2) asset access controls over such individuals. See FAM 360.11 through .18 for tests of IS controls.

d. For individuals with authorized access to assets over which asset access controls are insufficient, determine whether such individuals can affect any recording of transactions in the accounting records. If so, segregation of duties is insufficient, unless such access to accounting records is controlled. For example, the person who processes cash receipts may also be able to record entries in the accounting records. Such a person may be in a position to manipulate the accounting records to conceal a shortage in the cash account, unless another individual reviews all accounting entries that the person made (or should have been made).

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

Test IS Controls

.11 As discussed in FAM 350, the auditor documents relevant control activities in the SCE worksheet or equivalent. For each control activity in the SCE worksheet, the auditor should indicate whether it is an IS control. As discussed in FAM 270, such controls are often application and user controls. FAM 295 F provides details on the three types of IS controls—general controls, application controls, and user controls. The effectiveness of user controls typically depends on information system processing or the reliability of information it produces.

The auditor should also identify and understand the design of other IS application and general controls on which the effectiveness of the IS controls in the SCE worksheet depends. As the auditor learns more about the design and implementation of IS controls and identifies those that are likely to achieve control objectives, the auditor may identify other general controls that help ensure their effective operation. As such, the general controls identified during the internal control phase may differ from those identified during the planning phase (see FAM 270).

The auditor should identify and test the general controls and application controls on which the effectiveness of each IS control in the SCE worksheet depends. For example, if the IS control is the review of an exception report, the auditor would identify and test the application controls directly related to the production of the exception report, as well as the general and other application controls on which the reliability of the information in the exception report depends. This testing would include controls over the design and proper functioning of the business processes that generate the exception report and the reliability of the data used

to generate the exception report. In addition, the auditor would test the effectiveness of the user control (i.e., management review and follow-up on the items in the exception report).

As discussed in FAM 350.04, the auditor generally should test only the control activities necessary to achieve the objective and that are efficient to test, considering such factors as control dependencies, particularly for IS controls. A control dependency exists when the effectiveness of an internal control depends on the effectiveness of other internal controls. For example, when a dependency on information system processing exists, a control activity cannot reasonably be expected to achieve a specific control objective without effective information system processing—either in the performance of the control activity or in the production of information used in the performance of the control activity.

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

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

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

If controls are not effective, see FAM 350.06.

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

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

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

Test General Controls at the Entity-Wide and System Levels

.14 The auditor may test general controls through a combination of procedures, including observation, inquiry, or inspection (which includes a review of documentation on systems and procedures and may include reperformance) using appropriate test software. Although statistical sampling is generally not

used to test general controls, the auditor may use statistical sampling to test certain controls, such as those involving approvals.

.15 If general controls are not designed, implemented, or operating effectively, the auditor will generally be unable to obtain satisfaction that application controls are effective.[7] In such instances, the auditor should (1) determine and document the nature and extent of risks resulting from ineffective general controls, (2) identify and test any manual controls that achieve the control objectives that the IS controls in the SCE worksheet or equivalent document were unable to achieve, and (3) see FAM 580 for classifying and reporting control deficiencies.

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

Test General Controls at the Application Level

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

.17 If general controls are not operating effectively within the application, application controls and user controls generally will be ineffective.[8] In such instances, the engagement team should discuss the nature and extent of risks resulting from ineffective general controls. The auditor should determine whether to proceed with the evaluation of application controls and user controls.

Test Application Controls and User Controls

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

Perform Tests of the Components of Internal Control

.19 Based on AU-C 940.22, the auditor should test the operating effectiveness of entity-level controls related to the control environment, entity risk assessment, information and communication, and monitoring components that are important to the auditor's conclusion about whether these components are operating effectively to support effective internal control over financial reporting. Per AU-C 940.A35, the auditor's evaluation of entity-level controls can result in increasing

[7]See GAO, *Federal Information System Controls Audit Manual* (FISCAM), GAO-09-232G (Washington, D.C.: February 2009), for further information.

[8]Refer to FISCAM for further information.

or decreasing the testing that the auditor otherwise would have performed on other controls.

In the planning phase, the auditor assessed the design and implementation of the control environment, entity risk assessment, information and communication, and monitoring components (FAM 260). In the internal control phase, the auditor should test the operating effectiveness of entity-level controls related to these components, generally by a combination of observation, inquiry, and inspection (see FAM 350.13–.20). Controls within these four components that directly address risks of material misstatement at the assertion level are considered equivalent to control activities in the FAM and should be included in the SCE worksheet (see AU-C 315.A5).

The auditor's assessment of the design and implementation of control activities and information systems (part of the information and communication component) is discussed in FAM 340, 350, and 320, respectively. The auditor's tests of operating effectiveness of control activities and information systems are discussed in FAM 360.06 through 360.18.

Evaluate the Results of Control Tests

.20 The auditor should investigate and understand the reasons for any deviations from controls noted during control tests completed through the internal control phase. The auditor may find, for example, that significant subpopulations were not subject to controls or that controls were not applied during a specific period during the year. In such instances, the auditor may determine whether controls are effective for at least some parts of the population. For example, an otherwise effective control may not have been applied effectively in 1 month because of personnel turnover. For all but that month, the auditor may assess controls as effective and reduce related substantive testing. For the 1 month that controls were not effective, the auditor may increase substantive testing, if these tests are sufficient to reduce detection risk. The auditor also should determine whether other controls achieve the related control objective(s). Additionally, the auditor should gather sufficient evidence to report the control deficiency, as discussed in FAM 580.

.21 The auditor should evaluate whether the entity's controls sufficiently address identified risks of material misstatement due to fraud and the risk of management override of other controls (AU-C 940.16). For example, the use of a lockbox (a control activity) may reduce the risk of material misstatement associated with the completeness of cash receipts.

.22 The auditor should consider whether controls tested in the internal control phase and planned control tests in the testing phase (FAM 450) are likely to provide sufficient evidence about whether controls are operating effectively. For example, performing control tests that involve nonstatistical selection may provide sufficient evidence that a control is operating effectively for the items tested. However, since the auditor cannot project the results of nonstatistical selection to the population, the auditor should evaluate the results of the nonstatistical selection in conjunction with other sources of evidence to form an overall conclusion on the effectiveness of the controls tested. Other sources of evidence may include

- an understanding of the entity and its environment (FAM 220),

- inherent risk assessments (FAM 265),
- walk-throughs performed to confirm an understanding of information systems (FAM 320.02) and determine whether relevant control activities have been implemented (FAM 350.08),
- competence of entity personnel,
- the auditor's past experience,
- knowledge about other balances, and
- information obtained during interim substantive testing (FAM 420 and FAM 470).

If, after evaluating the results of control tests and other sources of evidence, the auditor concludes that sufficient evidence has not been obtained regarding the effectiveness of the controls tested, the auditor should perform additional control testing, for example, by selecting additional items to test or by performing sampling control tests (see FAM 430 and 450).

Evaluate the Effectiveness of the Entity's Internal Control over Financial Reporting

.23 Based on the results of control tests performed through the internal control phase and sampling control tests performed in the testing phase (see FAM 450), the auditor should evaluate the effectiveness of the entity's internal control over financial reporting and determine whether (1) each of the five components of internal control is designed, implemented, and operating effectively and (2) the five components are operating together in an integrated manner to achieve the entity's financial reporting objectives (AU-C 940.23). The auditor assesses the five components and underlying principles in the Green Book. In general, all components and principles are relevant for establishing an effective internal control system. See FAM 260 for discussion of the five components and underlying principles of internal control. In rare circumstances, there may be an operating or regulatory situation in which management has determined that a principle is not relevant for the entity to achieve its objectives and address related risks. If management determines that a principle is not relevant, management should support that determination with documentation that includes the rationale of how, in the absence of that principle, the associated component could be designed, implemented, and operating effectively.

Perform Tests of Compliance with FFMIA

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

370 – Assess Internal Control on a Preliminary Basis

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

.02 To assess the effectiveness of internal control, the auditor determines whether internal control provides reasonable assurance that control objectives are achieved. Internal control only provides reasonable assurance that misstatements, losses, or noncompliance, material in relation to the financial statements, would be prevented, or detected and corrected, during the period under audit. For each control objective that is not achieved, the auditor should obtain sufficient (1) information to determine whether the deficiency is a material weakness, significant deficiency, or other control deficiency and to report any deficiencies in the auditor's report or separate report to management (see FAM 580) and (2) evidence to support the preliminary assessment of the effectiveness of internal control and the risk of material misstatement.

Information System Controls

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

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

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

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

Financial Reporting Controls

.06 Based on audit procedures performed but before sampling control tests,[9] if any, the auditor generally should form a preliminary conclusion about

a. the effectiveness of financial reporting controls as of the end of the period (when the auditor is providing an opinion on internal control) and

b. the assessed level of control risk and the risk of material misstatement (i.e., combined assessment of inherent risk and control risk) during the period for each identified risk of material misstatement at the assertion level for which inherent risk is more than remote, for each material line item, account, note disclosure, and class of transactions.

.07 **Preliminary assessment of control risk.** Based on AU-C 315.38 and .A257, for each identified risk of material misstatement at the assertion level for which inherent risk is more than remote, for each material line item, account, note disclosure, and class of transactions, the auditor should assess control risk at one of three levels:

- **Low:** The auditor believes that controls **will likely** prevent, or detect and correct, on a timely basis any aggregate misstatements in excess of performance materiality that could occur in the assertion.
- **Moderate:** The auditor believes that controls **will less than likely but more than unlikely** prevent, or detect and correct, on a timely basis any aggregate misstatements in excess of performance materiality that could occur in the assertion.
- **High:** The auditor believes that controls **will unlikely** prevent, or detect and correct, on a timely basis any aggregate misstatements in excess of performance materiality that could occur in the assertion.

.08 **Preliminary assessment of the risk of material misstatement.** In assessing the risk of material misstatement, the auditor should evaluate the likelihood that a material misstatement would occur (inherent risk) (see FAM 265) and not be prevented or detected on a timely basis by the entity's internal control (control risk). The auditor should base this preliminary assessment of the risk of material misstatement on the auditor's assessment of inherent risk and control risk. Based on AU-C 315.38, if controls are not effective, the auditor should assess control risk at the maximum level. This results in the assessment of the risk of material misstatement being the same as the assessment of inherent risk.

.09 For each identified risk of material misstatement at the assertion level for which inherent risk is more than remote, for each material line item, account, note disclosure, and class of transactions, the auditor should assess the risk of material misstatement at one of three levels:

- **Low:** Based on the evaluation of inherent risk and control risk, but prior to the application of substantive audit procedures, the auditor believes that it is **unlikely** that any aggregate misstatements in the assertion exceed

[9]The auditor may assess the risk of material misstatement on a preliminary basis at an earlier point in the audit, if preferred. This may be particularly appropriate for a recurring audit where the auditor understands the design of the control environment, entity risk assessment, information and communication, and monitoring components of internal control.

performance materiality.

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

.10 As discussed in FAM 265, the auditor should evaluate whether the audit evidence obtained from the risk assessment procedures provides an appropriate basis for the identification and assessment of the risks of material misstatement. If not, the auditor should perform additional risk assessment procedures until audit evidence has been obtained to provide an appropriate basis. In identifying and assessing the risks of material misstatement, the auditor should take into account all audit evidence obtained from the risk assessment procedures, whether corroborative or contradictory to assertions made by management.

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

Budget Controls

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

Compliance Controls

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

a. conclude whether the entity's internal control provides reasonable assurance that the entity complied with the significant provisions of applicable laws, regulations, contracts, and grant agreements, noncompliance with which could have a material effect on the financial statements, and

b. report deficiencies in compliance controls that come to the auditor's attention

(see FAM 580).

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

Operations Controls

.14 If the results of control tests indicate that operations controls were not effective during the period, the auditor should not place reliance on those controls when designing other audit procedures. See FAM 580 regarding reporting deficiencies.

Reevaluation of Control Risk and the Risk of Material Misstatement

.15 After completing the testing phase, discussed in FAM 400, the auditor should reevaluate the preliminary assessment of control risk and the risk of material misstatement for financial reporting controls and control effectiveness for budget, compliance, and operations controls. If the auditor obtains new information that is inconsistent with the audit evidence on which the auditor originally based the identification or assessments of the risks of material misstatement, the auditor should revise the identification or assessment (AU-C 315.41). For example, if the test results are contrary to the preliminary assessment (e.g., control risk assessed at low, but the controls being tested were not operating effectively), the auditor should reevaluate the adequacy of the audit procedures performed and perform additional procedures as necessary. See FAM 470.01 and 530 for guidance on reassessing the risks of material misstatement.

380 – Other Considerations

Partial-Year Controls

.01 Management may implement changes to the entity's controls to make them more effective or efficient or to address deficiencies prior to the period-end. The auditor generally should test the operating effectiveness of both new and superseded controls, if they were effectively designed and implemented, to assess control risk for the entire period under audit (see FAM 350 and 360). If the auditor is providing an opinion on internal control, the auditor's tests of operating effectiveness of new controls should be sufficient to support the opinion on internal control over financial reporting as of the period-end date.

Planned Changes in Controls

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

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

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

390 – Documentation

.01 In addition to preparing an audit plan with control testing audit procedures and other documentation relevant to the internal control phase, the auditor should prepare the documents described in this section or their equivalent.

.02 The auditor should document the understanding of the operating effectiveness of each component of internal control (see FAM 360.19).

.03 The auditor should document the walk-throughs performed, including their dates, the information systems and control activities they encompassed, and key entity personnel who participated. The auditor should incorporate relevant information obtained from the walk-throughs into the applicable cycle memorandums and flowcharts, as discussed below.

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

.05 As the audit work is performed, the auditor may become aware of possible significant deficiencies or other matters that should be communicated to the entity, including those charged with governance. The auditor should document and communicate these as described in FAM 290, 580, and 590.

Cycle Memorandums and Flowcharts

.06 For each material line item, account, note disclosure, and class of transactions, or cycle (if the auditor groups related items by cycle), the auditor should prepare a cycle memorandum or equivalent that

- identifies the material line items, accounts, note disclosures, and classes of transactions included in the cycle and the significant financial management systems that support them (see FAM 235);
- documents the auditor's understanding of information system processing affecting the cycle (see FAM 320 and 340);
- describes relationships with other cycles;
- describes the operating policies and procedures affecting the cycle (see FAM 320); and
- describes the relevant control activities documented in the SCE worksheet (see FAM 350), including those
  - related to accounting estimates (AU-C 540.38a) and
  - that address the risks of material misstatement due to fraud (AU-C 240.43c).

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

.07 The auditor may also prepare **flowcharts** to complement the cycle memorandum and summarize the significant transaction flows in terms of

- input and report documents,
- processing steps,

- files used,
- organizational units involved,
- information systems, and
- interfaces with other cycles.

Flowcharts provide a good mechanism for documenting the process and the flow of transactions through the system. However, the auditor generally should avoid extreme detail, which makes the charts confusing and hard to follow. Complex systems, particularly those involving information technology, may be difficult to understand without a flowchart. Although the auditor may have gathered information on control activities when preparing flowcharts, the auditor should document these control activities in the SCE worksheet or equivalent.

.08 The auditor should document the understanding of relevant compliance and operations control systems in a memorandum and may prepare related flowcharts (see FAM 320).

SCE Worksheet

.09 Based on AU-C 315.42c, the auditor should document the evaluation of relevant control activities in the SCE worksheet or equivalent (see FAM 395 G). The auditor should document control tests in the control test audit plan and in accompanying documents. The auditor should also document any IS control tests, as discussed in FAM 370.05.

LIRA Form

.10 Based on the results of audit procedures performed through the internal control phase and the auditor's preliminary assessment of control risk and the risk of material misstatement, the auditor should complete the internal control phase columns of the LIRA form or equivalent (see FAM 395 H). If the auditor tentatively completed the internal control phase columns before testing control activities, the auditor should update the LIRA form as necessary.

395 A – Typical Relationships of Classes of Transactions to Line Items or Accounts

This section illustrates the typical relationships between classes of transactions and line items or accounts. For example, sources of significant accounting entries to the cash line item typically include the cash receipts and cash disbursements classes of transactions. The cash line item is also affected by the cash balance class of transactions, which includes reconciliations and maintenance of detailed records that support the period-end cash balance.

	Line Items / Accounts							
	Cash or FBWT	Accounts Receivable	Inventory	Property	Liabilities	Revenue	Expenses	Obligations
Classes of transactions								
Transaction related								
Billing		X				X		
Cash Receipts	X	X				X		
Purchasing			X	X	X		X	X
Cash Disbursements	X		X	X	X		X	X
Payroll Accruals					X		X	X
Line item/account related								
Cash Balance	X							
Accounts Receivable Balance		X						
Property Balance				X				

395 B – Assertions, Potential Misstatements, and Control Objectives

This section lists potential misstatements that could occur in each assertion, together with related control objectives. As discussed in FAM 265, the auditor tailors the potential misstatements illustrated in this section to the specific circumstances of the entity. These potential misstatements represent identified risks of material misstatement at the assertion level. The assertions and identified risks of material misstatement are used to prepare the first and second columns of the LIRA form at FAM 395 H and the SCE worksheet at FAM 395 G. The auditor also tailors the control objectives illustrated in this section, as appropriate, which may include supplementing them with additional objectives or subobjectives. These control objectives are used to prepare the sixth column of the SCE worksheet. However, this section is provided as a reference and does **not** require completion as a form.

Assertion	Potential misstatement	Control objective
Existence or occurrence	**Transaction related**	
	Occurrence/validity:	
	1. Recorded transactions and events did not actually occur or do not pertain to the entity.	1a. Recorded transactions, events, and related processing procedures are authorized by federal laws, regulations, contracts, grant agreements, and management policy. 1b. Appropriate individuals approve recorded transactions and events in accordance with management's general or specific criteria. 1c. Recorded transactions and events actually occurred and pertain to the entity. 1d. Transactions and events are recorded in the proper accounts.
	Cutoff:	
	2. Transactions and events are recorded in the current period but occurred in a different period.	2. Transactions and events recorded in the current period actually occurred in the current period.
	Summarization:	
	3. Transactions are summarized improperly, resulting in an overstated total.	3. The summarization of recorded transactions is not overstated.

Assertion	Potential misstatement	Control objective
Existence or occurrence	**Line item/account related**	
	Existence:	
	4. Recorded assets, liabilities, net position, and budgetary balances do not exist at a given date. Projected revenues or expenditures in the sustainability financial statements are not valid.	4a. Recorded assets, liabilities, net position, and budgetary balances exist at a given date. 4b. Assets, liabilities, net position, and budgetary balances are recorded in the proper accounts. 4c. Recorded assets, liabilities, net position, and budgetary balances of the entity, at a given date, are supported by appropriate detailed records that are accurately summarized and reconciled to the account balance. 4d. Projected revenues and expenditures in the sustainability financial statements are valid. 4e. Access to assets, critical forms, records, and processing and storage areas is permitted only in accordance with laws, regulations, and management policy.
Completeness	**Transaction related**	
	Transaction completeness:	
	5. Valid transactions and events are not recorded or are recorded in the incorrect accounts.	5. All valid transactions and events are recorded in the proper accounts.
	Cutoff:	
	6. Transactions and events occurred in the current period but are recorded in a different period.	6. All transactions and events that occurred in the current period are recorded in the current period.
	Summarization:	
	7. Transactions are summarized improperly, resulting in an understated total.	7. The summarization of recorded transactions is not understated.

Assertion	Potential misstatement	Control objective
	Line item/account related	
	Account completeness: 8. Assets, liabilities, net position, and budgetary balances of the entity exist but are not recorded in the proper period or accounts or are omitted from the financial statements. Projections in the sustainability financial statements do not include all estimated future revenues and expenditures at present value that should have been included.	8a. All assets, liabilities, net position, and budgetary balances that should have been recorded have been recorded in the proper period and accounts and are properly included in the financial statements. 8b. Projections in the sustainability financial statements include all estimated future revenues and expenditures at present value that should have been included.
Accuracy, valuation, and allocation	**Transaction related**	
	Accuracy: 9. Amounts and other data[10] relating to recorded transactions or events have not been appropriately recorded.	9. Amounts and other data relating to recorded transactions and events have been appropriately recorded.
	Line item/account related	
	Accuracy, Valuation, and Allocation: 10. Assets, liabilities, net position, budgetary balances, or projections in the sustainability financial statements have been included in the financial statements at inappropriate amounts. Resulting valuation or allocation adjustments have not been appropriately recorded.	10. Assets, liabilities, net position, budgetary balances, and projections in the sustainability financial statements have been included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments have been appropriately recorded.

[10]Other data includes information that is recorded along with the transaction amount and is necessary for the proper recording of the transaction, such as transaction description, transaction date, trading partner, cost center, fund code, and other accounting codes that the entity uses.

Assertion	Potential misstatement	Control objective
	Measurement:	
	11. Revenues, expenses, and budgetary activity included in the financial statements are measured improperly.	11. Revenues, expenses, and budgetary activity included in the financial statements are measured properly.
Rights and obligations	**Line item/account related**	
	Ownership:	
	12. Recorded assets are owned by others because of sale, consignment, or other contractual arrangements.	12. The entity owns (i.e., has valid title to) recorded assets.
	Rights:	
	13. The entity does not hold or control the rights to recorded assets or budgetary resources because of liens, pledges, or other restrictions.	13. The entity holds or controls the rights to recorded assets and budgetary resources at a given date.
	Obligations:	
	14. The entity does not have an obligation for recorded liabilities at a given date. Budgetary obligations do not pertain to the entity.	14a. Liabilities are the entity's obligations at a given date. 14b. Budgetary obligations pertain to the entity.
Presentation and disclosure	**Transaction and line item/account related**	
	Presentation:	
	15. Financial or other information in the financial statements is not appropriately aggregated or disaggregated or is not clearly described.	15. Financial and other information in the financial statements is appropriately aggregated or disaggregated and is clearly described.
	Consistency:	
	16. The current period financial statement components are based on accounting principles different from those used in the prior periods presented.	16. The financial statement components are based on accounting principles that are applied consistently from period to period.

Assertion	Potential misstatement	Control objective
	Disclosure: 17. Note disclosures are not appropriately measured or described or are not relevant and understandable in the context of the requirements of U.S. GAAP. Not all note disclosures that should have been included in the financial statements have been included. Disclosed transactions and events did not actually occur or pertain to the entity.	17. Note disclosures are appropriately measured and described and are relevant and understandable in the context of the requirements of U.S. GAAP. All note disclosures that should have been included in the financial statements have been included. Disclosed transactions and events have occurred and pertain to the entity.
	Transaction and line item/account related	
	Segregation of duties:[11] 18. The entity is exposed to loss of assets and various potential misstatements, including certain of those above, as the result of inadequate segregation of duties.	18. Persons do not have uncontrolled access to both assets and records; they are not assigned duties to put them in a position that would allow them to both commit and conceal errors or fraud.

[11]Segregation-of-duties controls are a type of safeguarding control and are designed to reduce the opportunities for any person to be in a position to both perpetrate and conceal misstatements, especially fraud, in the normal course of duties. Typically, an entity achieves adequate segregation of duties by establishing controls (such as segregating asset custody from recordkeeping functions) to prevent any person from having uncontrolled access to both assets and related records. The lack of segregation-of-duties controls may be pervasive and affect several assertions. The auditor should test segregation-of-duties controls as discussed in FAM 360.09 through .10.

395 C – Typical Control Activities

Authorization

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

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

Approval

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

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

Segregation of Duties

.03 Segregation-of-duties controls are designed to reduce the opportunities for someone to both cause and conceal errors or fraud. Typically, an entity achieves adequate segregation of duties by establishing controls (such as segregating

asset custody from recordkeeping functions) to prevent any person from having uncontrolled access to both assets and records. See FAM 330.08 and 360.09 through .10 for additional discussions of segregation-of-duties controls.

Design and Use of Documents and Records

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

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

Safeguards over Access to and Use of Assets and Records

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

- Cash receipt totals are recorded before cash is deposited.
- Secured facilities (locked rooms, fenced areas, vaults, etc.) are used. Access to critical forms and equipment (such as check-signing machines and signature stamps) is limited to authorized personnel.
- Access to information system programs and data files is restricted to authorized personnel. (For example, manual records, computer terminals, and backup files are kept in secured areas to which only authorized persons can gain access. Access is restricted by logical access controls.)
- Assets and records are protected against physical harm. (For example, intruder alarms, security guards, fire walls, a sprinkler system, etc., are used to prevent intentional or accidental destruction of assets and records.)
- Incoming and outgoing assets are counted, inspected, and received or disposed/transferred/sold only based on proper authorization (such as a

purchase order, contract, or shipping order) in accordance with established procedures.

- Procedures provide reasonable assurance that current files can be recovered in the event of a computer failure. (For example, the entity has implemented a backup and recovery plan, such as using on-premises or off-premises file backup, off-site storage of duplicate programs and operating procedures, and standby arrangements to use a second processing facility if the entire data center is destroyed.)
- Access to critical forms and records is restricted. (For example, secured conditions are established and maintained for manual records and media used to access assets, such as blank checks or forms for the release of inventory.)

Independent Checks

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

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

Valuation Controls of Recorded Amounts

.07 Controls in this category are designed to provide reasonable assurance that assets, liabilities, net position, budgetary resources, and projections in the sustainability financial statements are included in the financial statements at appropriate amounts. Typical valuation controls are as follows:

- The condition and marketability of assets is periodically evaluated. (For example, inventory is periodically reviewed for physical damage, deterioration, or obsolescence, or receivables are evaluated for collectability.)
- Recorded data are compared with information from an independent third party. (For example, recorded cash is reconciled to bank statements, and suppliers' accounts are reconciled to monthly statements from suppliers.)
- Assessed values (such as independent appraisals of assets) are compared with the accounting records.
- Budgetary balances are reconciled to audited proprietary balances. (For example, the receipt of goods or services, recorded as expenses in proprietary accounts, decreases undelivered orders balances in budgetary accounts.)
- Methodologies, assumptions, and data used in deriving the sustainability financial statements are reviewed for reasonableness.

Summarization of Accounting Data

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

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

Rights and Obligations Controls

.09 Controls in this category are designed to provide reasonable assurance that (1) the entity owns recorded assets, with the ownership supported by appropriate documentation; (2) the entity holds or controls the rights to its assets and budgetary resources at a given date; (3) recorded liabilities reflect the entity's obligations at a given date; and (4) budgetary obligations pertain to the entity at a given date. Procedures that are typical of this category of controls include the following:

- Policies and procedures are documented (such as policy, procedures, and training manuals, together with organization charts) for initiating transactions and for identifying and monitoring those transactions and accounts warranting attention with respect to ownership.

- Policies and procedures are documented for initiating and monitoring transactions and accounts related to obligations.
- Significant transactions require the approval of senior management.
- Reported results and balances are compared with plans and authorizations.

Presentation and Disclosure Controls

.10 Controls in this category are designed to provide reasonable assurance that (1) financial and other information in the financial statements is appropriately aggregated or disaggregated and is clearly described, (2) financial statement components are based on accounting principles that are applied consistently from period to period, (3) note disclosures are appropriately measured and described and are relevant and understandable in the context of the requirements of U.S. GAAP, (4) all note disclosures that should have been included in the financial statements have been included, and (5) disclosed transactions and events have occurred and pertain to the entity. Procedures that are typical of this category of controls include the following:

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

395 D – Selected Statutes Relevant to Budget Execution

.01 **Antideficiency Act:** This statute places limitations on the obligation and expenditure of government funds. Expenditures and obligations may not exceed the amounts available in the related appropriation or fund accounts. Unless expressly allowed by law, amounts may not be obligated before they are appropriated. Additionally, the amount of obligations and expenditures may not exceed the amount of the apportionments received. (See 31 U.S.C. §§ 1341-1342, 1351, and 1517 for further information.) Also, see FAM 803.

.02 **Purpose statute:** This statute states that appropriations may be obligated and expended only for the purposes stated in the appropriation. (See 31 U.S.C. § 1301 for further information.)

.03 **Time statute:** This statute states that appropriations may be obligated or expended only during the period of availability specified by law. (See 31 U.S.C. §1502 for further information.)

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

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

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

395 E – Budget Execution Process

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

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

.02 The design of the budget execution process is of interest to the auditor when testing the statement of budgetary resources and reconciliation of net cost to net outlays and when evaluating an entity's internal control relating to budget execution.[12]

a. Congress provides an entity with an **appropriation (or other budget authority)**, which is authority provided by law to enter into obligations that

[12]For additional information on budget execution, see part 4 of OMB Circular No. A-11, *Preparation, Submission, and Execution of the Budget*, issued on August 11, 2023. OMB circulars are updated periodically, and the current version can be found on the OMB website at https://www.whitehouse.gov/omb/information-for-agencies/circulars/ (accessed June 3, 2024). Another useful document is GAO, *A Glossary of Terms Used in the Federal Budget Process*, GAO-05-734SP (Washington, D.C.: September 2005). The USSGL and related accounting in the TFM can be found at https://tfx.treasury.gov (accessed June 3, 2024).

result in immediate or future outlays (2 U.S.C. § 622(2)).

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

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

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

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

e. The entity incurs an **obligation**. An obligation, as defined in OMB Circular No. A-11, is a binding agreement that will result in outlays, immediately or in the future. GAO's Federal Budget Glossary[13] defines obligation as a definite commitment that creates a legal liability of the government for the payment of goods and services ordered or received, or a legal duty on the part of the United States that could mature into a legal liability by virtue of actions on the part of the other party beyond the control of the United States. Payment may be made immediately or in the future. An agency incurs an obligation, for example, when it places an order, signs a contract, awards a grant, purchases a service, or takes other actions that require the government to make payments to the public or from one government account to another. The entity should comply with legal requirements before recording obligations against appropriation accounts (title 7 of *GAO's Policy and Procedures Manual for Guidance of Federal Agencies*). These legal requirements include determining whether the purpose, the amount, and the timing of when the obligation was incurred are in accordance with the appropriation. Additionally, there are legal requirements concerning the documentary evidence necessary for recording an obligation.

The reconciliation of net cost to net outlays reconciles the budgetary resources obligated for an entity's programs and operations, which are shown on the statement of budgetary resources and determined using budgetary accounting with the net cost of operations shown on the statement of net

[13]GAO, *A Glossary of Terms Used in the Federal Budget Process,* GAO-05-734SP (Washington, D.C.: September 2005).

cost, which is determined using proprietary accounting.

f. The entity records **expended authority** when the budget authority has been used, such as by the receipt and acceptance of goods or services ordered.[14]

g. The entity records an **outlay**, which, as used in the President's budget, congressional budget documents, and the statement of budgetary resources, refers to payments (cash disbursements) made to liquidate obligations. The statement of budgetary resources reconciles obligations incurred net of offsetting collections to net outlays.

h. The entity records a **deobligation**, which is the entity's cancellation or downward adjustment (i.e., reduction) of previously incurred obligations. The entity should not cancel or reduce an obligation until it has made a formal decision to do so, supported by any necessary documentation that has been fully executed (e.g., SF-30 for contract amendments). There may be specific statutory or other requirements concerning deobligation. For example, transactions authorized by the Economy Act are limited by the statutory requirement that the amount obligated by the ordering appropriation is required to be deobligated to the extent that the agency or unit filling the order has not incurred obligations before the end of the period of availability of the ordering appropriation. Additionally, there are stewardship reasons for timely deobligating funds.

i. When appropriations are deobligated before the expiration of the period of availability, the deobligated amount is available for incurring new obligations for an authorized use. This means that annual appropriated funds may be reobligated in the fiscal year in which the funds were appropriated, while multiyear or no-year appropriated funds may be reobligated in the same or subsequent fiscal years. When appropriations are deobligated after the expiration of the period of availability, the deobligated amount is not available to incur a new obligation unless specifically authorized; however, the deobligated amount is available to cover appropriate adjustments to obligations in the expired account. Deobligated no-year funds are generally available for obligation on the same basis as if they had never been obligated.

j. The appropriation account **expires** when, according to time restrictions contained in the appropriation, the appropriation is no longer available for

[14]In the normal flow of business, when obligations are incurred, a credit to "undelivered orders" or "unexpended obligations - unpaid" is recorded (USSGL account 4801) with a debit to commitments (USSGL account 4700 or 4720). When the budget authority has been used, such as by the receipt of goods or services ordered, the obligation is debited (USSGL account 4801) with a credit to "delivered orders-unpaid" or "expended authority - unpaid" (USSGL account 4901). At this time, a proprietary accounting entry is also made to debit expenditures (usually USSGL account 6100) with a credit to accounts payable (USSGL account 2110). When the obligation is paid and the outlay is made, the transaction is credited to "delivered orders - paid" or "expended authority - paid" (USSGL account 4902). At this time, a proprietary accounting entry is also made to debit accounts payable (USSGL account 2110) with a credit to FBWT (USSGL account 1010). For additional transaction details, see TFM's U.S. Standard General Ledger Accounting Transactions supplement.

new obligations.[15] Adjustments may be made for valid obligations that were either (1) recorded at an estimated amount that differs from the actual amount[16] or (2) incurred before the authority expired but not recorded. Adjustments may be recorded for 5 years after the appropriation expires. For both expired accounts and closed accounts, the entity's obligations and expenditures may not exceed the related budget authority. See OMB Circular No. A-11, part 4, for additional guidance on these types of adjustments and transactions.

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

- canceled orders or orders for which delivery is no longer likely,
- refunds received in the current period that relate to recovery of erroneous payments or accounting errors,
- legal and valid obligations that were previously unrecorded, and
- differences between the estimated and actual obligation amounts.

k. After the 5-year period, the budget authority for the expired accounts is **canceled** and the expired accounts are **closed**.[17] No further adjustments or outlays may be made in those closed accounts. Payments for any unliquidated obligations in closed accounts may be made from unexpired appropriations that have the same general purpose (but are limited in aggregate to 1 percent of the current-year appropriation). For both expired accounts and closed accounts, the entity's obligations and expenditures may not exceed the related budget authority. See OMB Circular No. A-11, part 4, for additional guidance on these types of adjustments and transactions.

[15]Unobligated amounts are debited and moved to "allotments – expired authority" with a credit to USSGL account 4650. For no-year appropriations (i.e., those available for obligation for an indefinite period), the appropriation account does not expire. Consistent with 31 U.S. C. § 1555, the appropriation account is closed, and any remaining balance (whether obligated or unobligated) in that account is canceled (and thus no longer available for obligation or expenditure for any purpose) if (1) the entity head or the President determines that the purposes for which the appropriation was made has been carried out and (2) no disbursement has been made against the appropriation for 2 consecutive fiscal years.

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

[17]Expired authority (USSGL account 4650) is debited and moved to "canceled authority" by a credit to USSGL account 4350. At this time, a proprietary entry is made to debit and reduce "unexpended appropriations" (USSGL account 3106) and to credit and reduce FBWT (USSGL account 1010).

395 F – Budget Control Objectives

.01 This section lists budget control objectives by steps in the budget process. The auditor may use these control objectives for the audit of the statement of budgetary resources and the reconciliation of net cost to net outlays, the evaluation of financial reporting controls, or the evaluation of compliance controls. The auditor may evaluate the design of many of these controls when evaluating the design of controls over expenses, disbursements, and liabilities. When testing control effectiveness, the auditor may test these controls at the same time, which is referred to as multipurpose testing.

a. **Appropriations (or other forms of budget authority).** The recorded appropriation (or other form of budget authority) is the same as that made available in the appropriation or other appropriate statutes, including restrictions on amount, purpose, and timing.

b. **Apportionments.** The recorded apportionments agree with the OMB apportionments (as indicated on the apportionment schedules), and the total amount apportioned does not exceed the total amount appropriated.[18]

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

d. **Commitments.** The auditor may not be concerned with controls over budgetary commitments because commitments are not required by law or regulation nor are they formal/official uses of budget authority. Controls over budgetary commitments are a type of operations control.

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

e. **Obligation transactions.** The control objectives relating to obligation transactions are as follows:

- **Validity/occurrence.** Obligations recorded are valid. An obligation is valid only if it meets these criteria:
  - The obligation has been incurred and represents a valid obligation. This is usually evidenced by appropriate supporting documentation, such as a purchase order or contract.

    The auditor may look for instances of “block obligating” or “block dumping,” which occur when an entity records obligations to “reserve” funds even though the goods or services have not been ordered. This is most likely to occur near the expiration of an appropriation and

[18]OMB apportionments may, as a result of impoundments (rescissions or deferrals), be less than the amount of the apportionments requested by the entity. The auditor generally should notify OGC of any impoundments that come to the auditor’s attention. OMB may also approve different amounts available than those requested by time period, activity, project, or object class.

usually occurs in large dollar services and equipment contracts. The auditor may look for such signs as large, even-amount obligations near the end of the fiscal year for annual appropriations or during the last year of a multiyear appropriation account.

- The purpose of the obligation is one for which the appropriation was made.
- The obligation was incurred within the time that the appropriation was made available for new obligations.
- The obligation did not exceed the amount allotted or appropriated by statute nor was it incurred before the appropriation became law, unless otherwise provided by law.
- The obligation complies with any other legally binding restrictions, such as obligation ceilings or earmarks, identified in the planning phase.
- The obligation has not subsequently been deobligated or canceled. The entity should not cancel or reduce an obligation until it has made a formal decision to do so, supported by any necessary documentation that has been fully executed (e.g., SF-30 for contract amendments). There may be specific statutory or other requirements concerning deobligation. For example, transactions authorized by the Economy Act are limited by the statutory requirement that the amount obligated by the ordering appropriation is required to be deobligated to the extent that the agency or unit filling the order has not incurred obligations before the end of the period of availability of the ordering appropriation.
- For adjustments to obligations in expired accounts, objectives are as follows:
  i. If the adjustment represents a “contract change,” as defined in OMB Circular No. A-11, refer to the entity’s reporting and approval requirements in that circular.
  ii. The adjustment represents a valid increase or decrease to the entity’s budgetary obligation, supported by any necessary documentation that has been fully executed (e.g., SF-30 for contract amendments).
  iii. The adjustment does not cause the entity to exceed the amount allotted or appropriated by statute.
  iv. The adjustment is recorded during the period when the account is available for adjustments (5 years) and was made for a valid obligation incurred before the authority expired.
  v. New obligations are not to be recorded in expired accounts.

- **Completeness.** All obligation transactions are recorded.
- **Accuracy.** Obligations are accurately recorded based on the entity’s budgetary obligation for the payment of goods and services ordered or

received and other unliquidated obligations.[19] The entity's budgetary obligation is not the same as an entity's accounting liability, which is a probable future outflow or other sacrifice of resources as a result of past transactions or events (e.g., receipt of goods or services). The entity's budgetary obligation is reported on the statement of budgetary resources, whereas its accounting liability is reported on the balance sheet.

- **Cutoff.** Obligations are recorded in the proper period.
- **Classification.** Obligations are recorded in the proper appropriation or fund accounts (also by program and by object, if applicable), including the proper appropriation year if the account is multiyear. Examples of programmatic account classifications are school lunch program and nutrition education and training. Examples of object account classifications are salaries, rent, and travel.

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

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

[19]Other unliquidated obligations include legal duties on the part of the United States that could mature into legal liabilities by virtue of actions on the part of the other party beyond the control of the United States. For example, in a GAO legal decision, an entity that, at the time of grant award, accepted a legal duty to cover the benefits of new participants at the time of a grant award was required to record its maximum amount of liability because the amount of payment was under the control of the grantee. See *Obligational Practices of the Corporation for National and Community Service*, B-300480, Apr. 9, 2003*; Corporation for National and Community Service: Amount of Obligations,* B-300480.2, June 6, 2003.

and by object, if applicable), including the proper appropriation year if the account is multiyear.

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

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

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

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

  In addition, total payments of unliquidated obligations that relate to closed accounts do not exceed the limits described in OMB Circular No. A-11 (for annual accounts, 1 percent of the account's current year appropriation; for multiyear accounts, 1 percent of all appropriations that

are available for obligation for the same purpose, which is a single, cumulative limit).

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

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

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

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

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

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

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

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

Budget Control Objectives under the Federal Credit Reform Act

.02 The Federal Credit Reform Act (FCRA) contains provisions regarding the recording and reporting of activity related to direct loans, loan guarantees, and modifications of these items for budget accounting purposes. Definitions of these and other FCRA terms are provided in paragraph .03 below. For transactions and account balances related to these types of activities, the auditor generally should use the budget control objectives listed in FAM 395 F and supplement them with the following budget control objectives related to FCRA. Additional guidance on FCRA accounting for budget purposes is included in OMB Circular No. A-11.

Also, see Federal Financial Accounting and Auditing Technical Releases No. 3, *Auditing Estimates for Direct Loan and Loan Guarantee Subsidies Under the Federal Credit Reform Act* (as amended), and No. 6, *Preparing Estimates for Direct Loan and Loan Guarantee Subsidies Under the Federal Credit Reform Act*.

a. **Obligation transactions.** Obligation transactions include direct loan obligations, loan guarantee commitments, and modifications that change the cost of an outstanding direct loan or loan guarantee (modifications do not include changes to outstanding direct loans or loan guarantees that are within the terms of existing contracts or through other existing authorities). The supplemental control objective relating to obligation transactions under FCRA is as follows:

- **Valuation.** When funds are obligated for a direct loan or loan guarantee, the estimated cost shall be based on the "current" assumptions,[20] adjusted to incorporate the terms of the loan contract, for the fiscal year in which the funds are obligated.
  - The cost of a direct loan is recorded at the net present value, at the time when the loan is disbursed, of estimated cash flows for
    i. loan disbursements;
    ii. principal repayments;
    iii. interest payments; and
    iv. other payments by or to the government over the life of the loan, including fees, penalties, and other recoveries, as well as adjustments for estimated prepayments, delinquencies, and defaults.

    These estimated cash flows include the effects of the timing and are discounted using the appropriate rate as described below. Administrative costs and any incidental effects on governmental receipts and outlays are not included in the cost of the direct loan (2 U.S.C. § 661a(5)(A), (B)).
  - The cost of a loan guarantee is recorded at the net present value, at the time when the related guaranteed loan is disbursed, of the cash flows for
    i. estimated amounts and timing of payments by the government for defaults, delinquencies, interest subsidies, or other payments, excluding administrative costs, and
    ii. estimated amounts and timing of payments to the government for origination and other fees, penalties, and recoveries.

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

[20]The term current has the same meaning as in section 250(c)(9) of the Balanced Budget and Emergency Deficit Control Act of 1985.

661a(5)(A), (C)).

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

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

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

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

- **Limitation.** Total obligations and total expended authority transactions do not exceed the appropriation amount or other statutory limitations that may exist by appropriation period. Specifically, see the following:
  - Direct loan obligations made on or after October 1, 1991, do not exceed the available appropriation or other budget authority.

- Modifications made to direct loan obligations or direct loans do not exceed the available appropriation or other budget authority. (Note: Prior to performing any control or compliance tests, the auditor should discuss with OGC the applicability of this budget restriction to direct loans and direct loan obligations that were outstanding prior to October 1, 1991.)
- Obligations for new loan guarantee commitments made on or after October 1, 1991, do not exceed the available appropriation or other budget authority.
- Modifications made to loan guarantee commitments or outstanding loan guarantees do not exceed the available appropriation or other budget authority. (Note: Prior to performing any control or compliance tests, the auditor should discuss with OGC the applicability of this budget restriction to loan guarantees or loan guarantee commitments that existed prior to October 1, 1991.)

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

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

.03 Definitions used in FCRA are as follows:

a. **Direct loans** are disbursements of funds by the government to nonfederal borrowers under contracts that require the repayment of such funds with or without interest. Direct loans also include the purchase of, or participation in, loans made by other lenders. Direct loans do not include the acquisition of federally guaranteed loans in satisfaction of default claims or the price support loans of the Commodity Credit Corporation (2 U.S.C. § 661a(1)).

b. **Direct loan obligations** are binding agreements by a federal agency to make direct loans when specified conditions are fulfilled by the borrowers (2 U.S.C. § 661a(2)).

c. **Loan guarantees** are any guarantees, insurance, or other pledges with respect to the payment of all or a part of the principal or interest on any debt obligations of nonfederal borrowers to nonfederal lenders, but do not include the insurance of deposits, shares, or other withdrawable accounts in financial institutions (2 U.S.C. § 661a(3)).

d. **Loan guarantee commitments** are binding agreements by a federal agency to make loan guarantees when specified conditions are fulfilled by borrowers, lenders, or any parties to guarantee agreements (2 U.S.C. § 661a(4)).

e. **Cost** is defined as the estimated long-term cost to the government of a direct loan or loan guarantee, calculated on a net present value basis, or modification thereof, excluding administrative costs and any incidental effects on governmental receipts or outlays (2 U.S.C. § 661a(5)). These calculations

are described in further detail under the valuation control objective for obligations in FAM 395 F.

f. **Credit program accounts** are the budget accounts associated with each program account into which appropriations to cover the costs of direct loans or loan guarantee programs are made and from which such costs are disbursed to the financing accounts (2 U.S.C. § 661a(6)).

g. **Financing accounts** are the nonbudget accounts associated with each credit program account that hold balances, receive the cost payment from the credit program account, and include all other cash flows to and from the government resulting from direct loan obligations or loan guarantee commitments made on or after October 1, 1991 (2 U.S.C. § 661a(7)).

h. **Liquidating accounts** are the budget accounts that include all cash flows to and from the government resulting from direct loan obligations or loan guarantee commitments made prior to October 1, 1991. These accounts are shown on a cash basis (2 U.S.C. § 661a(8)).

i. **Modifications** are government actions that alter the estimated cost of an outstanding direct loan (or direct loan obligation) or loan guarantee (or loan guarantee commitment) from the current estimate of cash flows (2 U.S.C. § 661c(9)). These include the sale of loan assets, with or without recourse, and the purchase of guaranteed loans. They also include the actions resulting from new statutes, or from the exercise of administrative discretion under existing law, that directly or indirectly alter the estimated cost of outstanding direct loans (or direct loan obligations) or loan guarantees (or loan guarantee commitments).

   For example, a policy change affecting the repayment period or interest rate for a group of existing loans would be a modification. Changes within the terms of existing contracts or through other existing authorities are not modifications under FCRA. In addition, “work outs” of individual loans, such as a change in the amount or timing of payments to be made, are not modifications. The effects of these changes are included in the annual reestimates of the estimated net present value of the obligations.

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

395 G – Specific Control Evaluation Worksheet

.01 For each identified risk of material misstatement at the assertion level (identified risk) for which inherent risk is more than remote, for each material line item, account, note disclosure, and class of transactions, the auditor should use the SCE worksheet or equivalent to document the assessment of control risk. When preparing the LIRA form at FAM 395 H or equivalent, the auditor will use this assessment of control risk, along with the assessment of inherent risk, to assess the risk of material misstatement, which provides an appropriate basis for the design of further audit procedures.

.02 For each identified risk for which inherent risk is more than remote, the SCE worksheet or equivalent should include the following information:

- control objectives that address the risk;
- evaluation of the design, implementation, and operating effectiveness of the relevant control activities necessary to achieve each control objective; and
- assessment of control risk.

.03 As discussed in FAM 330, each line item, account, and note disclosure is affected by input from one or more classes of transactions. As such, the risks that affect a class of transactions will also affect the related line items, accounts, and note disclosures. To avoid duplication in documentation, the auditor may use one SCE worksheet to document the control risk assessment for a material class of transactions and all the material line items, accounts, and note disclosures it affects. If a class of transactions, such as journal vouchers, is not directly related to a specific line item, account, or note disclosure, the auditor may prepare an SCE worksheet for that class of transactions only.

.04 The auditor may prepare the SCE worksheet as follows:

- In the header, identify the material class of transactions. If the SCE worksheet covers multiple classes of transactions, such as those within a cycle, list all the classes of transactions. The auditor will list the related line items in column 3, as explained below.
- In column 1, list each assertion that is applicable to the class of transactions and all the material line items, accounts, and note disclosures it affects. The auditor obtains this information from the LIRA form(s) or equivalent for the class of transactions (see FAM 395 H). If an assertion is not applicable, the auditor does not need to list it in column 1. While all five assertions described in FAM 235 are applicable to line item/account-related classes of transactions that support balances that exist at period-end (e.g., asset, liability, net position, or budgetary balances), only the existence or occurrence; completeness; accuracy, valuation, and allocation; and presentation and disclosure assertions are applicable to transaction-related classes of transactions (e.g., billing, purchasing, cash receipts, and cash disbursements), as illustrated in FAM 395 B.
- In columns 2 and 3, for each assertion identified in column 1, list the material line items that the class of transactions affects and the identified risks, which are obtained from the LIRA form(s) or equivalent (see FAM 395 H). For example, identified risks for the cash receipts class of transactions would

typically be documented in the cash, accounts receivable, and revenue LIRA forms (see FAM 395 A for typical relationships of classes of transactions to line items or accounts).

Also indicate in column 3 the assertion affected for each line item listed and reference the LIRA form that addresses it. For example, a misstatement in the occurrence assertion for the cash receipts class of transactions would affect the existence assertion for the cash line item. It would also affect the occurrence assertion for the revenue line item or the completeness assertion for the accounts receivable line item.

- In columns 4 and 5, list the inherent risk assessment and significant risk determination for each identified risk. The auditor obtains this information from the LIRA form(s) or equivalent (i.e., where the inherent risk assessment and significant risk determination are performed and documented). The auditor should consider this assessment and determination in identifying relevant control activities in column 7 (see FAM 350.05).

The following columns should be completed for each identified risk for which inherent risk is more than remote. If inherent risk is remote, enter N/A for columns 6 through 14. As discussed in FAM 310.09, in rare circumstances in which the auditor assessed all identified risks at remote for a material line item, account, note disclosure, or class of transactions, the auditor should perform control tests, as appropriate, if the auditor is providing an opinion on internal control.

- In column 6, identify the related internal control objectives for each identified risk. See FAM 330 and 395 B for guidance on identifying control objectives.
- In column 7, list internal control activities selected for testing that achieve each internal control objective identified (i.e., relevant control activities). In the FAM, control activities include controls in the control environment, entity risk assessment, information and communication, and monitoring components that directly address risks of material misstatement at the assertion level (see FAM 360.19). FAM 395 C illustrates typical control activities to achieve financial reporting control objectives.[21]
- In column 8, indicate whether each control activity is either (a) an IS control, (b) a manual control, or (c) both an IS control and a manual control. As noted in FAM 350.11, the auditor generally should obtain concurrence from an IS controls auditor on the auditor's identification of IS controls. IS controls consist of those internal controls that depend on information system processing and include general controls, application controls, and user controls.

  A user control can be either (a) a manual control or (b) both an IS control and a manual control. A user control is considered both an IS control and a manual control if it depends on information system processing. Conversely, a user control is considered a manual control if it does not depend on information system processing. Manual controls do not depend on

[21]The auditor may (1) commingle the documentation of compliance (including budget), operations, and safeguarding controls with that of financial reporting controls to the extent appropriate on an SCE worksheet; (2) list these controls in a separate section(s) within the SCE worksheet; or (3) present each type of control in a separate SCE worksheet.

information system processing—either in the performance of the control activity or in the production of information used to perform the control activity. See FAM 295 F for additional information on the types of IS controls.

- In column 9, based on procedures performed in the internal control phase, conclude as to whether the control activity is effectively designed and implemented. As noted in FAM 360.11, the auditor should also identify and assess the design and implementation of other IS controls (application and general controls) on which the effectiveness of the IS controls in the SCE worksheet depends. An IS controls auditor will often need to assist the auditor in assessing the design and implementation of IS controls.
- In column 10, reference the audit documentation supporting the conclusion on whether the control activity is effectively designed and implemented.
- In column 11, based on the results of the internal control and testing phase audit procedures, enter a conclusion regarding the operating effectiveness of each control activity. As part of this assessment, the auditor assesses the operating effectiveness of other IS controls on which the effectiveness of the IS controls included in the SCE worksheet depends. An IS controls auditor will often need to assist the auditor in assessing the operating effectiveness of IS controls.
- In column 12, reference the audit procedures in the detailed control testing audit plan that were designed to test each control determined to be effectively designed and implemented.
- In column 13, conclude on whether each internal control objective has been achieved. This conclusion will need to consider the impact of results for each internal control activity related to the internal control objective. For example, one of the four control activities for achieving a control objective may have been ineffective; however, the combination of all control activities achieved the control objective.
- In column 14, assess control risk as either low, moderate, or high based on the effectiveness of related control activities and whether control objectives are achieved as indicated in columns 11 and 13, respectively (see FAM 370.07).

.05 In the internal control phase, the auditor should document on the LIRA form at FAM 395 H or equivalent the preliminary assessments of the effectiveness of financial reporting controls and control risk from the SCE worksheets, based on the results of audit procedures performed through the internal control phase (e.g., walk-throughs and control tests that involve nonstatistical selection). Based on the results of audit procedures performed in the testing phase (e.g., sampling control tests), the auditor should determine if the preliminary assessments remain appropriate and should update them if necessary. The auditor should also note on the LIRA form any control deficiencies identified during testing of the control activities in the SCE worksheet.

Note: The auditor should tailor the risks in column 2 to the specific entity. For illustrative purposes, some columns contain example text. The auditor should complete all columns as applicable.

SPECIFIC CONTROL EVALUATION

ENTITY: _____

DATE OF FINANCIAL STATEMENTS: _____

CLASS OF TRANSACTIONS: [e.g., Cash Receipts]

INTERNAL CONTROL PHASE SIGN-OFFS **TESTING PHASE SIGN-OFFS**

Preparer & Date: _____ _____

Primary Reviewer & Date: _____ _____

IDENTIFIED RISKS OF MATERIAL MISSTATEMENT AT THE ASSERTION LEVEL		**INHERENT RISK ASSESSMENT** (from LIRA)			**CONTROL OBJECTIVES AND ACTIVITIES**			**DESIGN AND IMPLEMENTATION OF CONTROL ACTIVITIES**		**CONTROL RISK ASSESSMENT**			
Assertions	**Identified Risks of Material Misstatement**	**Related Line Items, Assertions, and LIRA References**	**Inherent Risk Assessment**[22] (remote, low, moderate, high)	**Significant Risk?** (yes, no, N/A)	**Internal Control Objectives (ICO)** (for each identified risk of material misstatement for which inherent risk is more than remote)	**Internal Control Activities (ICA)**	**Type of ICA: IS, Manual (M), or Both IS and Manual (B)**	**Is the ICA Effectively Designed and Implemented?**	**Audit Doc. Ref.**	**Is the ICA Operating Effectively?**	**Audit Plan Testing Step**	**Is the ICO Achieved?**	**Control Risk Assessment** (low, moderate, high, N/A)
1	2	3	4	5	6	7	8	9	10	11	12	13	14
Existence or Occurrence	**Transaction related**												
	Occurrence/validity: 1. Recorded transactions and events did not actually occur or do not pertain to the entity.	[e.g., cash - existence, LIRA.1]			1a. Recorded transactions, events, and related processing procedures are authorized by federal laws, regulations, contracts, grant agreements, and management policy.								
		[e.g., revenue - occurrence, LIRA.2]			1b. Appropriate individuals approve recorded transactions and events in accordance with management's general or specific criteria.								

[22]If inherent risk is assessed at remote, enter N/A in columns 5 through 14. If the auditor is providing an opinion on internal control, the auditor should perform control tests for all material line items, accounts, note disclosures, and classes of transactions.

					1c. Recorded transactions and events actually occurred and pertain to the entity.									
					1d. Transactions and events are recorded in the proper accounts.									
	Cutoff: 2. Transactions and events are recorded in the current period but occurred in a different period.				2. Transactions and events recorded in the current period actually occurred in the current period.									
	Summarization: 3. Transactions are summarized improperly, resulting in an overstated total.				3. The summarization of recorded transactions is not overstated.									
	Line item/account related													
	Existence: 4. Recorded assets, liabilities, net position, and budgetary balances do not exist at a given date. Projected revenues or expenditures in the sustainability statements are not valid.	N/A			4a. Recorded assets, liabilities, net position, and budgetary balances exist at a given date.									
					4b. Assets, liabilities, net position, and budgetary balances are recorded in the proper accounts.									
					4c. Recorded assets, liabilities, net position, and budgetary balances of the entity, at a given date, are supported by appropriate detailed records that are accurately summarized and reconciled to the account balance.									
					4d. Projected revenues and expenditures in the sustainability statements are valid.									

					4e. Access to assets, critical forms, records, and processing and storage areas is permitted only in accordance with laws, regulations, and management policy.								
Completeness	**Transaction related**												
	Transaction completeness: 5. Valid transactions and events are not recorded or are recorded in the incorrect accounts.				5. All valid transactions and events are recorded in the proper accounts.								
	Cutoff: 6. Transactions and events occurred in the current period but are recorded in a different period.				6. All transactions and events that occurred in the current period are recorded in the current period.								
	Summarization: 7. Transactions are summarized improperly, resulting in an understated total.				7. The summarization of recorded transactions is not understated.								
	Line item/account related												
	Account completeness: 8. Assets, liabilities, net position, and budgetary balances of the entity exist but are not recorded in the proper period or accounts or are omitted from the				8a. All assets, liabilities, net position, and budgetary balances that should have been recorded have been recorded in the proper period and accounts and are properly included in the financial statements.								

	financial statements. Projections in the sustainability statements do not include all estimated future revenues and expenditures at present value that should have been included.				8b. Projections in the sustainability statements include all estimated future revenues and expenditures at present value that should have been included.								
Accuracy, Valuation, and Allocation	**Transaction related**												
	Accuracy: 9. Amounts and other data relating to recorded transactions or events have not been appropriately recorded.				9. Amounts and other data relating to recorded transactions and events have been appropriately recorded.								
	Line item/account related												
	Accuracy, valuation, and allocation: 10. Assets, liabilities, net position, budgetary balances, or projections in the sustainability statements have been included in the financial statements at inappropriate amounts. Resulting valuation or allocation adjustments have not been appropriately recorded.				10. Assets, liabilities, net position, budgetary balances, and projections in the sustainability statements have been included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments have been appropriately recorded.								

	Measurement: 11. Revenues, expenses, and budgetary activity included in the financial statements are measured improperly.				11. Revenues, expenses, and budgetary activity included in the financial statements are measured properly.								
Rights and Obligations	**Line item/account related**												
	Ownership: 12. Recorded assets are owned by others because of sale, consignment, or other contractual arrangements.				12. The entity owns (i.e., has valid title to) recorded assets.								
	Rights: 13. The entity does not hold or control the rights to recorded assets or budgetary resources because of liens, pledges, or other restrictions.				13. The entity holds or controls the rights to recorded assets and budgetary resources at a given date								
	Obligations: 14. The entity does not have an obligation for recorded liabilities at a given date. Budgetary obligations do not pertain to the entity.				14a. Liabilities are the entity's obligations at a given date.								
					14b. Budgetary obligations pertain to the entity.								

Presentation and Disclosure	**Transaction and line item/account related**														
	Presentation: 15. Financial or other information in the financial statements is not appropriately aggregated or disaggregated or is not clearly described.				15. Financial and other information in the financial statements is appropriately aggregated or disaggregated and is clearly described.										
	Consistency: 16. The current period financial statement components are based on accounting principles different from those used in the prior periods presented.				16. The financial statement components are based on accounting principles that are applied consistently from period to period.										
	Disclosure: 17. Note disclosures are not appropriately measured or described or are not relevant and understandable in the context of the requirements of U.S. GAAP. Not all note disclosures that should have been included in the financial statements have been included. Disclosed transactions and events did not actually occur or pertain to the entity.				17. Note disclosures are appropriately measured and described and are relevant and understandable in the context of the requirements of U.S. GAAP. All note disclosures that should have been included in the financial statements have been included. Disclosed transactions and events have occurred and pertain to the entity.										

	Segregation of duties:[23] 18. The entity is exposed to loss of assets and various potential misstatements, including certain of those above, as the result of inadequate segregation of duties.	N/A		18. Persons do not have uncontrolled access to both assets and records; they are not assigned duties to put them in a position that would allow them to both commit and conceal errors or fraud.								[Reference the control risk assess-ments above for which segregation of duties procedures were performed.]
	Laws, regulations, contracts, and grant agreements[24]	[Reference the inherent risk assessments above to which compliance with laws, regulations, contracts, and grant agreements is relevant.]										[Reference the control risk assess-ments above to which compliance is relevant.]

[23]Segregation of duties involves segregating work responsibilities so that one individual does not control all critical stages of a process, allowing that person to both cause and conceal misstatements whether due to error or fraud. In assessing control risk for the identified risks of material misstatements listed above, the auditor considers the risk that inadequate segregation of duties could result in material misstatements to the financial statements. Segregation of duties procedures as discussed in FAM 360 should be documented, and the conclusions should be summarized here.

[24]In assessing inherent risk and control risk for the identified risks of material misstatement listed above, the auditor considers the risk that noncompliance with laws, regulations, contracts, and grant agreements could result in material misstatements to the financial statements. The auditor may commingle compliance controls (including budget) with financial reporting controls as appropriate, list them in a separate section of this SCE worksheet, or include them in a separate SCE worksheet. See FAM 800 for examples of compliance SCE worksheets for laws and regulations.

395 H – Line Item Risk Analysis Form

.01 The auditor should use the LIRA form or equivalent to document the auditor's identification and assessment of risks of material misstatement at the assertion level for material line items, accounts, note disclosures, and the related classes of transactions (see FAM 235 and 265). For each identified risk of material misstatement at the assertion level (identified risk), the LIRA form or equivalent should document the assessed level of inherent risk. For each identified risk for which inherent risk is more than remote, the LIRA form or equivalent should include the following information:

- the determination of whether the risk is a significant risk;
- the assessed level of control risk;
- the assessed level of risk of material misstatement (i.e., combined inherent risk and control risk); and
- the planned nature, extent, and timing of substantive audit procedures to address the risk.

.02 For purposes of preparing the LIRA form, the auditor may group related line items, accounts, and note disclosures, as appropriate. Typically, the auditor will use one LIRA form to document identified risks for a material line item and all the material accounts, note disclosures, and classes of transactions related to it. If a class of transactions, such as journal vouchers, or a note disclosure, such as fiduciary activities, is not directly related to a line item (e.g., it affects many line items), the auditor may prepare a LIRA form for that class of transactions or note disclosure only.

.03 The auditor may prepare the LIRA form as follows:

- In the header, identify the material line item and enter the line item total. Also list the accounts and balances that make up the line item and the related note disclosures. Immaterial accounts may be listed following material accounts. This would allow the auditor to demonstrate that all accounts making up the line item total have been considered. If the line item consists of many accounts, the auditor may list the accounts or additional accounts in an addendum to the LIRA form. The auditor will list the related classes of transactions in column 3, as explained below. However, if the LIRA form is prepared for a class of transactions or note disclosure only, the auditor should replace the header information with the class of transactions or note disclosure.

Planning Phase:

- In column 1, list each of the five assertions discussed in FAM 235. If an assertion is not applicable to the line item or any of its related accounts, note disclosures, or classes of transactions, the auditor may exclude the assertion from the LIRA form. For example, the auditor may exclude the rights and obligations assertion from the LIRA form for net cost line items. For balance sheet line items, the auditor should include all five assertions.
- In column 2, list the identified risks for the line item and its related accounts, note disclosures, and classes of transactions (classes of transactions are

identified in column 3). The auditor tailors the potential misstatements in FAM 395 B to the specific circumstances of the entity. The auditor may identify multiple types of potential misstatements in an assertion (see FAM 330). Misstatements are classified as transaction related or line item/account related. For line items that reflect the accumulation of activities and events that occurred during the period under audit (e.g., revenues, expenses, and budgetary activity), the auditor typically considers transaction-related misstatements. For line items that reflect balances at period-end (e.g., asset, liability, net position, or ending budgetary balances), the auditor typically considers both transaction-related and line item/account-related misstatements. For example, for the cash line item, the auditor would identify potential misstatements in existence but also in occurrence/validity because cash is affected by the cash receipt and disbursement transactions that occurred during the year. Some types of potential misstatements may affect only a portion or component of a line item. Additionally, some potential misstatements may not be applicable for a given line item or its related accounts, note disclosures, and classes of transactions. For example, the potential misstatements related to existence, ownership, rights, and obligations in FAM 395 B are not applicable to net cost line items.

These potential misstatements represent identified risks of material misstatement at the **assertion level**. Risks of material misstatement identified at the **financial statement level** are documented in the audit strategy and do not need to be included on the LIRA form unless they also affect the assessment of risks at the assertion level (see FAM 290.07m).

- In column 3, for each identified risk, list the classes of transactions that contribute to the risk and reference the SCE worksheets that address them. For example, on the cash LIRA form, the auditor would typically identify a risk related to occurrence (i.e., recorded transactions did not actually occur). For this risk, the auditor would typically list cash receipts and cash disbursements as the classes of transactions that contribute to the risk. Other risks for which the auditor might list cash receipts and cash disbursements include those related to transaction completeness, cutoff, summarization, accuracy, presentation, consistency, and disclosure.

  On the cash LIRA form, the auditor would typically also identify a risk related to existence (e.g., recorded cash does not exist at a given date). For this risk, the auditor would typically list the cash balance class of transactions, which consists of activities that support the period-end cash balance. Other risks for which the auditor might list the cash balance class of transactions include those related to account completeness, accuracy, ownership, rights, presentation, consistency, and disclosure. See FAM table 330.1 and FAM 395 A for additional guidance on the relationships between classes of transactions and line items. If the LIRA form is prepared for a class of transactions only, the auditor may enter N/A in this column and include a reference to the related SCE worksheet in the header of column 3.

The following columns should be completed for each class of transactions that contributes to each identified risk.

- In column 4, summarize the inherent risk considerations, including fraud risk and noncompliance considerations, that support the assessment of inherent risk in column 5 (see FAM 220). For example, the auditor may assess

inherent risk at high for an identified risk in the valuation of the net receivables line item due to (1) the materiality of the receivables and potential allowance, (2) the subjectivity of management's judgment related to the loss allowance, or (3) management's history of aggressively challenging any proposed adjustments to the valuation of the receivables.

The auditor's considerations for a class of transactions may be documented on multiple LIRA forms. In these cases, the considerations should be consistent among the multiple LIRA forms. For example, the auditor may identify cash receipts as a class of transactions that contributes to a risk related to occurrence/validity on the cash LIRA form. Since the receipt of cash usually result in a debit to cash and a credit to revenue or accounts receivable, the auditor's considerations for cash receipts on the cash LIRA form should be consistent with those documented for cash receipts on the revenue LIRA form or accounts receivable LIRA form.

- In column 5, indicate whether the assessment of inherent risk is remote, low, moderate, or high (see FAM 265.23). As in column 4, this may be based on and should be consistent with the inherent risk assessments for other line items affected by the same class of transactions. If the auditor assesses inherent risk at remote, the auditor does not need to perform further audit procedures to address the risk. In these cases, the auditor should enter N/A in columns 6 through 10. The auditor should continue to complete the LIRA form for the identified risks for which inherent risk is assessed at low, moderate, or high. As discussed in FAM 265.26, in rare circumstances in which the auditor assessed all identified risks at remote for a material line item, account, note disclosure, or class of transactions, the auditor should nonetheless perform substantive procedures for that line item, account, note disclosure, or class of transactions. Additionally, the auditor should perform control tests, as appropriate, if the auditor is providing an opinion on internal control.
- In column 6, indicate whether the identified risk is a significant risk. As in column 4, this should be consistent with the significant risk identification for other line items affected by the same class of transactions. A significant risk is an identified risk of material misstatement (1) for which the assessment of inherent risk is high; (2) due to fraud, for which inherent risk is more than remote; or (3) arising from transactions with disclosure entities, related parties, and public-private partnerships that are also significant unusual transactions, for which inherent risk is more than remote. Significant risks require special audit considerations and are discussed throughout the FAM. See FAM 265 for additional guidance on identifying and responding to significant risks.

Internal Control Phase:

The following columns should be completed for each class of transactions that contributes to each identified risk for which inherent risk is more than remote.

- In column 7, indicate the assessment of control risk, which is obtained from the SCE worksheet that addresses the class of transactions contributing to the identified risk.
- In column 8, assess the risk of material misstatement as either low, moderate, or high (see FAM 370.09). This is a combined assessment of

inherent risk (column 5) and control risk (column 7). In making this assessment, consider the extent to which control risk mitigates inherent risk. If control risk is high, the assessment of risk of material misstatement would be the same as the assessment of inherent risk.

As in column 4, this should be consistent with the risk assessment for other line items affected by the same class of transactions.

Testing Phase:

The following columns should be completed for each class of transactions that contributes to each identified risk for which inherent risk is more than remote.

- In column 9, summarize the nature, extent, and timing of planned substantive audit procedures that address the risk (see FAM 420).
- In column 10, provide a reference to the related audit procedure step number(s) in the testing audit plan.

If the audit procedures for a class of transactions is already documented on another LIRA form, the auditor may refer to the other LIRA form in columns 9 and 10.

.04 If the results of audit procedures in the testing phase (e.g., sampling control tests and substantive procedures, see FAM 400) indicate that the assessment of inherent risk, control risk, and the risk of material misstatement at the assertion level was not appropriate, the auditor should document the revised assessment and the factors contributing to the revised assessment in the LIRA form or other document, such as the audit summary memo.

Note: The auditor should tailor the risks in column 2 to the specific entity. For illustrative purposes, some columns contain example text. The auditor should complete all columns as applicable.

ENTITY: _____

DATE OF FINANCIAL STATEMENTS: _____

LINE ITEM & TOTAL: [e.g., Cash $100,000,000]

ACCOUNTS & BALANCES: _____

NOTE DISCLOSURES: _____

LINE ITEM RISK ANALYSIS

Preparer and Date: _____

Primary Reviewer and Date: _____

PLANNING PHASE						INTERNAL CONTROL PHASE		TESTING PHASE	
IDENTIFIED RISKS OF MATERIAL MISSTATEMENT AT THE ASSERTION LEVEL			INHERENT RISK ASSESSMENT			CONTROL RISK ASSESSMENT from SCEs (low, moderate, high, N/A)	RISK OF MATERIAL MISSTATEMENT ASSESSMENT Combined Inherent Risk and Control Risk (low, moderate, high, N/A)	SUBSTANTIVE AUDIT PROCEDURES	
Assertions	**Identified Risks of Material Misstatement**	**Classes of Transactions & SCE References**	**Inherent Risk Considerations** (including fraud risk and noncompliance considerations)	**Inherent Risk Assessment** (remote, low, moderate, high)[25]	**Significant Risk?** (yes, no, N/A)			**Nature, Extent, & Timing** (interim/year-end)	**Audit Plan Testing Step**
1	2	3	4	5	6	7	8	9	10
Existence or Occurrence	**Transaction related**								
	Occurrence/validity 1. Recorded transactions and events did not actually occur or do not pertain to the entity.	[e.g., cash receipts, SCE.1]	[columns 4 - 8 should be consistent with the Revenue LIRA related to cash receipts]					[e.g., see Revenue LIRA]	
		[e.g., cash disbursements, SCE.2]	[columns 4 - 8 should be consistent with the Net Cost LIRA related to cash disbursements]					[e.g., see Net Cost LIRA]	

[25]If inherent risk is assessed at remote, enter N/A for columns 6 through 10. If inherent risk is remote for all identified risks of material misstatement, see FAM 395 H.03 for instructions.

	Cutoff: 2. Transactions and events are recorded in the current period but occurred in a different period.								
	Summarization: 3. Transactions are summarized improperly, resulting in an overstated total.								
	Line item/account related								
	Existence: 4. Recorded assets, liabilities, net position, and budgetary balances do not exist at a given date. Projected revenues or expenditures in the sustainability statements are not valid.	[e.g., cash balance, SCE.3]							
Completeness	**Transaction related**								
	Transaction completeness: 5. Valid transactions and events are not recorded or are recorded in the incorrect accounts.								
	Cutoff: 6. Transactions and events occurred in the current period but are recorded in a different period.								

	Summarization: 7. Transactions are summarized improperly, resulting in an understated total.								
	Line item/account related								
	Account completeness: 8. Assets, liabilities, net position, and budgetary balances of the entity exist but are not recorded in the proper period or accounts or are omitted from the financial statements. Projections in the sustainability statements do not include all estimated future revenues and expenditures at present value that should have been included.								

Accuracy, Valuation, and Allocation	**Transaction related**								
	Accuracy: 9. Amounts and other data relating to recorded transactions or events have not been appropriately recorded.								
	Line item/account related								
	Accuracy, valuation, and allocation: 10. Assets, liabilities, net position, budgetary balances, or projections in the sustainability statements have been included in the financial statements at inappropriate amounts. Resulting valuation or allocation adjustments have not been appropriately recorded.								
	Measurement: 11. Revenues, expenses, and budgetary activity included in the financial statements are measured improperly.	[e.g., N/A]							

Rights and Obligations	**Line item/account related**								
	Ownership: 12. Recorded assets are owned by others because of sale, consignment, or other contractual arrangements.								
	Rights: 13. The entity does not hold or control the rights to recorded assets or budgetary resources because of liens, pledges, or other restrictions.								
	Obligations: 14. The entity does not have an obligation for recorded liabilities at a given date. Budgetary obligations do not pertain to the entity.	[e.g., N/A]							
Presentation and Disclosure	**Transaction and line item/account related**								
	Presentation: 15. Financial or other information in the financial statements is not appropriately aggregated or disaggregated or is not clearly described.	[e.g., cash receipts, SCE.1]							
		[e.g., cash disbursements SCE.2]							
		[e.g., cash balance, SCE.3]							

	Consistency: 16. The current period financial statement components are based on accounting principles different from those used in the prior periods presented.								
	Disclosure: 17. Note disclosures are not appropriately measured or described or are not relevant and understandable in the context of the requirements of U.S. GAAP. Not all note disclosures that should have been included in the financial statements have been included. Disclosed transactions and events did not actually occur or pertain to the entity.								

SECTION 400

Testing Phase

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410 – Overview of the Testing Phase

.01 Based on AU-C 500.06, audit evidence is information used by the auditor in arriving at the conclusions on which the auditor's reports are based. Audit evidence is information to which audit procedures have been applied and consists of information that corroborates or contradicts assertions in the financial statements. During the testing phase of the audit, the auditor gathers sufficient appropriate audit evidence to report on

- the entity's financial statements;
- the entity's internal control;
- whether the entity's financial management systems are in substantial compliance with the three requirements of Federal Financial Management Improvement Act of 1996 (FFMIA) (for CFO Act agencies); and
- the entity's compliance with significant provisions of applicable laws, regulations, contracts, and grant agreements.

.02 The auditor should evaluate information to be used as audit evidence by taking into account

- the relevance and reliability of the information, including its source, and
- whether such information corroborates or contradicts assertions in the financial statements (AU-C 500.07).

The relevance of the information to be used as audit evidence relates to the logical connection with, or bearing upon, the auditor's purposes (AU-C 500.A19). The reliability of audit evidence depends on the nature and source of the audit evidence and the circumstances under which it is obtained (AU-C 500.A22). The reliability of information to be used as audit evidence is affected to varying degrees by its accuracy, completeness, authenticity, and susceptibility to management bias (AU-C 500.A27). Contradictory information may be relevant even when the source of that information is less reliable than the source of corroborative information (AU-C 500.A37).

.03 The auditor's evaluation of the information to be used as audit evidence should include

- evaluating whether the information is sufficiently precise and detailed for the auditor's purposes and
- obtaining audit evidence about the accuracy and completeness of the information, as necessary (AU-C 500.08).

.04 Audit sampling is often used in audit testing.[1] The auditor uses professional judgment,[2] as well as knowledge of sampling methods, in applying audit

[1]Audit testing can be performed using either audit sampling or nonstatistical selection. Audit sampling methods involve selecting individual items from a population with the objective of reaching a conclusion on all the items in the population. Audit sampling can be either statistical (intended to be representative of and statistically projected to the population) or nonstatistical (intended to be representative of but not statistically projectable to the population). Nonstatistical selection involves selecting items to reach a conclusion only on the items tested.

[2]All decisions should be documented and supported.

sampling. When designing an audit sample, the auditor should consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn (AU-C 530.06). FAM 400 provides a framework for applying audit sampling to financial audits but is not a comprehensive discussion. Additional background and guidance on audit sampling is provided in the AICPA's audit guide, *Audit Sampling*.

The auditor generally should consult with an audit sampling specialist for assistance in designing and evaluating audit samples and in evaluating the costs and benefits when deciding the appropriate type of audit sampling to use, unless the auditor determines only basic statistical concepts are applied.

.05 During this phase, the auditor performs activities for each type of test to

- determine the nature, extent, and timing of further audit procedures (FAM 420);
- design tests (FAM 430); and
- perform tests and evaluate results (FAM 440).

.06 The types of procedures performed in the testing phase are as follows:

- **Sampling control tests** that may be performed by the auditor to obtain evidence about achieving specific control objectives. If the auditor obtains sufficient evidence regarding the effectiveness of controls through control tests performed in the internal control phase (see FAM 360), sampling control tests are not necessary. Further guidance on sampling control tests is in FAM 450.
- **Compliance tests** are performed by the auditor to obtain evidence about compliance with significant provisions of applicable laws, regulations, contracts, and grant agreements. Further guidance on compliance tests is in FAM 460.
- **Substantive procedures** are performed by the auditor to obtain evidence that provides reasonable assurance about whether the financial statements and related assertions are free of material misstatement. Further guidance on substantive procedures is in FAM 470, FAM 475, and FAM 480.

.07 Audit documentation of the nature, extent, and timing of procedures performed during this test phase, as well as conclusions reached, is discussed in FAM 490.

420 – Determine the Nature, Extent, and Timing of Further Audit Procedures

Design Further Audit Procedures

.01 As discussed in FAM 200 (Planning Phase) and FAM 300 (Internal Control Phase), the auditor performs risk assessment procedures that provide a basis for designing further audit procedures to obtain audit evidence about control effectiveness and about assertions in material line items, accounts, note disclosures, and classes of transactions. Obtaining audit evidence is a cumulative process. If information to be used as audit evidence has been prepared using the work of management's specialists (those with expertise in a field other than accounting or auditing, such as actuarial calculations, valuations, or engineering data), see FAM 625.

.02 The auditor should design and implement overall responses to address the risks of material misstatement at the financial statement level (AU-C 330.05). In doing so, the auditor should consider matters such as the knowledge, skill, and ability of personnel assigned significant engagement responsibilities; whether certain aspects of the engagement require a specialist; and the appropriate level of supervision of audit staff. See AU-C 330.A1 through .A3 for further guidance on developing overall responses to address the risks of material misstatement at the financial statement level.

.03 The auditor should design and perform further audit procedures whose nature, extent, and timing are based on, and are responsive to, the risks of material misstatement at the assertion level and in a manner that is not biased toward obtaining audit evidence that may be corroborative or toward excluding audit evidence that may be contradictory. When evaluating audit evidence with respect to the risks of material misstatement, the auditor maintains professional skepticism, including when considering information that may be used as audit evidence and what procedures would be appropriate in the circumstances (AU-C 330.06).

.04 Based on AU-C 330.07, in designing the further audit procedures to be performed, the auditor should

a. consider the reasons for the assessed level of risk of material misstatement at the assertion level for each material line item, account, note disclosure, and class of transactions, including

- the likelihood and magnitude of misstatement due to the particular characteristics of the material line item, account, note disclosure, or class of transactions (inherent risk) and
- the effectiveness of relevant control activities (control risk),[3] and

[3]According to OMB audit guidance, for those controls that have been suitably designed and implemented, the auditor should perform sufficient tests of such controls to conclude whether they are operating effectively (i.e., sufficient tests of controls to support a low level of assessed control risk). Thus, the auditor should not elect to forgo control tests because it is more efficient to extend substantive and compliance audit procedures.

b. obtain more persuasive audit evidence the higher the auditor's assessment of risk of material misstatement.

The design of specific audit procedures is further discussed in FAM 430; sampling control tests in FAM 450; compliance tests in FAM 460; FFMIA tests in FAM 701 and 701 A; and substantive procedures in FAM 470, FAM 475, and FAM 480.

Determine the Nature of Tests

.05 Further audit procedures consist of tests of controls and substantive procedures. The auditor should determine the nature of sampling control tests, compliance tests, and substantive procedures that will achieve the audit objectives.

.06 Substantive procedures are classified as either substantive analytical procedures or detail tests. Substantive analytical procedures involve comparing the recorded test amount with the auditor's expectation of the recorded amount and investigating any significant differences between these amounts. Further information on substantive analytical procedures is in FAM 475.

.07 The higher the auditor's assessment of risk of material misstatement, the more reliable and relevant the audit evidence from substantive procedures needs to be. The auditor should determine the nature of the population and the objectives of the test procedures.

Determine the Extent of Tests

.08 For each type of test, the auditor should determine the extent of tests to be performed. The extent of sampling control tests is a function of the auditor's preliminary assessment of control risk, tolerable rate of deviation, and the rate of control deviations expected.[4] The extent of compliance tests is a function of the effectiveness of compliance controls. The extent of substantive procedures is a function of the risk of material misstatement, expected misstatement, and tolerable misstatement.

Determine the Timing of Tests

.09 Based on AU-C 330.23 and OMB audit guidance, if substantive procedures are performed at an interim date, the auditor should cover the remaining period by performing substantive procedures, combined with tests of controls, for the intervening period. As discussed in FAM 295 D, the auditor may conduct some tests before the date of the financial statements (interim testing) or conduct all tests as of the date of the financial statements. FAM 495 C provides guidance on interim testing, tests of the period between the interim date and the date of the financial statements (the roll-forward period), and related documentation.

[4]The rate of control deviations expected is an anticipation of the deviation rate in the entire population.

430 – Design Tests

.01 After considering the risk of material misstatement discussed in FAM 420, the auditor should design specific tests to be performed. To realize efficiencies in tests that involve audit sampling, the auditor can perform several tests on a common sample (multipurpose testing).[5] The auditor generally should minimize the number of separate sampling applications performed on the same population by attempting to effectively achieve as many objectives as possible using the items selected for testing.

.02 When designing control, compliance, and detail tests, the auditor should determine the means of selecting items for testing that are effective in meeting the purpose of the audit procedure (AU-C 330.25). Items can be selected using either audit sampling methods or nonstatistical selection. Audit sampling methods involve selecting individual items from a population with the objective of reaching a conclusion on all the items in the population. Audit sampling can be either statistical (intended to be representative of and statistically projected to the population) or nonstatistical (intended to be representative of but not statistically projectable to the population). Nonstatistical selection involves selecting items to reach a conclusion only on the items tested.

For control tests, the auditor generally should use nonstatistical selection (FAM 360) or statistical sampling (FAM 450). For compliance tests, the auditor generally should use statistical sampling (FAM 460). For detail tests, the auditor may use any of the selection methods (i.e., nonstatistical selection, statistical sampling, and nonstatistical sampling) discussed in FAM 480, as appropriate.

.03 When determining the selection method to use during a multipurpose test, the auditor generally should use the selection method appropriate for substantive detail tests in the particular situation. This selection method is usually the most efficient because generally sampling control and compliance tests may be based on any type of audit sample.

For example, the auditor may use a statistical sample of property additions to (a) substantively test the amount of additions and (b) test financial reporting controls over property acquisition. If a substantive test would require 135 sample items selected using monetary unit sampling (MUS) and if the test of financial reporting controls would require 45 sample items, the auditor may either test controls relating to all 135 sample items or select a separate sample of 45 sample items from the general population for control testing.

.04 In using multipurpose testing, the auditor may have begun substantive procedures before determining whether the test of controls supports the auditor's assessed level of control risk. Therefore, an auditor planning to use multipurpose testing will have made a preliminary judgment that there is an acceptably low risk that the rate of deviations from the prescribed control in the population exceeds the tolerable rate of deviations the auditor is willing to accept without altering the

[5]In addition to number of sampling applications, many factors influence efficiency, such as sample size, number of locations it is necessary to visit to achieve audit objectives, nature of the audit procedures, extent of review required, and whether rework can be avoided by designing easy-to-follow procedures.

planned assessed level of control risk (see the AICPA's audit guide, *Audit Sampling*).

It should be noted that multipurpose tests may not be efficient if conducted during the first 2 years of a new audit. This is because the auditor may not be as aware of the operating effectiveness of the controls in place at an entity in a new audit, and the rate of deviation may be higher than expected.

440 – Perform Tests and Evaluate Results

.01 The auditor should perform the planned tests as designed in FAM 420 and FAM 430 and should evaluate the results of each type of test separately, without respect to whether the items were chosen as part of a multipurpose test. Guidance on performing and evaluating the results is presented for each type of test in the following sections:

- FAM 450 – Sampling Control Tests
- FAM 460 – Compliance Tests
- FAM 470 – Substantive Procedures

.02 The auditor should evaluate (a) the results of the audit sample, including sampling risk, and (b) whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested (AU-C 530.14)

If the results of tests are different from what was expected during design of the tests, the auditor may want to expand the audit sample to test additional items; however, this is usually not appropriate. In a well-designed audit sample, the expanded sample will not usually materially change the sample results. For MUS and attribute samples, unless the auditor plans for the expansion of the sample in advance,[6] expansion of the sample is generally not appropriate. See the AICPA's audit guide, *Audit Sampling,* for further guidance. The auditor should consult with the audit sampling specialist before expanding any samples (see FAM 450.20, FAM 460.02, and FAM 480.26).

.03 The auditor should evaluate the effect of the findings of the substantive procedures performed in the audit of financial statements on the effectiveness of internal control over financial reporting. This should include, at a minimum, the following:

- The risk assessments in connection with the selection and application of substantive procedures, especially those related to fraud.
- Findings with respect to illegal acts and transactions with disclosure entities, related parties, and public-private partnerships.
- Indications of management bias in making accounting estimates and in selecting accounting principles.
- Misstatements detected by substantive procedures. The extent of such misstatements might alter the auditor's judgment about the effectiveness of controls. The absence of misstatements detected by substantive procedures, however, does not provide audit evidence that controls related to the assertion being tested are effective (AU-C 330.16).

.04 In evaluating information to be used as audit evidence, the auditor should consider whether the results of audit procedures provide a basis for concluding

[6]Usually, this is covered by selecting a larger audit sample than needed. If the auditor believes a larger audit sample is necessary, the auditor generally should consult with an audit sampling specialist.

on the sufficiency and appropriateness of audit evidence obtained (AU-C 500.09).

.05 The auditor should determine whether modifications or additions to audit procedures are necessary to resolve inconsistencies in, or doubts about the reliability of, audit evidence, including when

- audit evidence obtained from one source is inconsistent with that obtained from another source or
- the results of an audit procedure are inconsistent with the results of another audit procedure (AU-C 500.10).

Assess the Risk of Material Misstatement

.06 Assessing the risk of material misstatement due to error or fraud is a cumulative, ongoing process throughout the audit (see FAM 265). During testing, the auditor may become aware of additional fraud risk factors or other conditions that may affect the auditor's assessment of the risk of material misstatement, such as

- discrepancies in the accounting records,
- conflicting or missing evidential matter, or
- problematic or unusual relationships between management and the entity being audited.

In response to fraud risk factors or other conditions, the auditor should determine whether to perform additional or different audit procedures (see FAM 540.24–.28), including consultation with the Special Investigator Unit and Office of the General Counsel (OGC).

450 – Perform Sampling Control Tests

.01 Based on AU-C 330.08 and OMB audit guidance,[7] the auditor should design and perform control tests to obtain sufficient appropriate audit evidence about the operating effectiveness of relevant control activities if they have been implemented (see FAM 360). In designing and performing tests of controls, the auditor should obtain more persuasive audit evidence the greater the reliance the auditor places on the effectiveness of a control activity (AU-C 330.09).

.02 The auditor may test controls that provide documentary evidence of their existence and application by inspecting this evidence. If the auditor cannot obtain sufficient evidence by performing control tests in the internal control phase (see FAM 360), the auditor may obtain more evidence by inspecting individual items selected using audit sampling procedures in the testing phase.

For efficiency, the auditor may use a single statistical sample to test a combination of controls, compliance, and balances (test of details) (i.e., multipurpose testing). Alternatively, the auditor may design a statistical sample to test controls alone. In this case, the auditor should use attribute sampling, selected either randomly or systematically where appropriate, as described beginning in FAM 450.06.

.03 When planning sampling control tests, the auditor should determine a sample size sufficient to reduce sampling risk to an acceptably low level (AU-C 530.07). The auditor should determine

- the objectives of the test (including what constitutes a deviation),
- the population (including sampling unit and time frame),
- the method of selecting the statistical sample, and
- the sample design and resulting sample size.

The auditor should include the sampling plan in the audit documentation. See FAM 495 D for example documentation.

Document Objectives of the Tests

.04 The auditor should document the objectives of each control test. In designing statistical samples for control tests, the auditor should plan to evaluate operating effectiveness in terms of the rate of deviations in units or dollars from prescribed controls. This involves defining (1) the specific control activity to be tested and (2) what constitutes an error, exception, or control failure. The auditor should define control deviations in terms of control activities not followed. For example, the auditor may define a deviation in cash disbursements as “invoice not approved and initialed by an authorized individual.”

For financial reporting control tests, the objective is to support the preliminary assessment of control risk as either moderate or low. For compliance and

[7]According to OMB audit guidance, for those controls that have been suitably designed and implemented, the auditor should perform sufficient tests of such controls to conclude whether the controls are operating effectively (i.e., sufficient tests of controls to support a low level of assessed control risk). Thus, the auditor should not elect to forgot control tests because it is more efficient to extend substantive and compliance audit procedures.

operations control tests, the objective is to support the preliminary assessment of the control as effective. In addition, for financial reporting and compliance control tests, the objective is obtaining evidence to support the auditor's report on internal control.

Define the Population

.05 In defining the population, the auditor should identify the whole set of items on which the auditor needs to reach a conclusion and from which the statistical sample will be drawn. This includes

- describing the population and its source,
- conducting data reliability tests to determine whether the population is complete and valid (see FAM 480.01 for further guidance),
- determining the evidence available to be tested, and
- defining the period covered by the test.

When multiple locations are involved, the auditor should determine whether to use one population of all or several locations, or whether to use separate populations. The auditor may be able to use one population if the controls at each location are components of one overall control system. In making this decision, the auditor may evaluate such factors as

- the extent of uniformity of the controls and their applications at each location,
- whether significant changes can be made to the controls or their applications at the local level,
- the amount and nature of centralized oversight or control over local operations, and
- whether there could be a need for separate conclusions for each location.

If the auditor concludes that the locations are separate populations, the auditor should select separate statistical samples at each location and evaluate the results of each statistical sample separately.

Choose Method of Selection

.06 The auditor should select items for the statistical sample in such a way that the auditor can reasonably expect the sample to be representative of the relevant population and likely to provide the auditor with a reasonable basis for conclusions about the population (AU-C 530.08). For tests of controls, attribute sampling achieves this objective. Attribute sampling requires random or systematic, if appropriate, selection of sample items without considering the transaction's dollar amount or other special characteristics. The auditor may also use computer software, such as IDEA, to make random selections.

Determine Sample Size

.07 To determine the sample size, the auditor uses professional judgment to determine four factors:

- tolerable rate of deviation of the population to be tested (maximum rate of deviations from the prescribed control that the auditor is willing to accept without altering the preliminary control risk);
- expected rate of deviation of the population to be tested (expected error rate);
- the desired level of assurance (complement of risk of overreliance) that the tolerable rate of deviation is not exceeded by the actual rate of deviation in the population—the auditor may decide the desired level of assurance based on the extent to which the auditor's risk assessment takes into account relevant controls (AU-C 530.A13); and
- confidence level.

Once the auditor determines these factors, the auditor may use computer software (such as IDEA) to determine sample size and to select statistical samples for testing. The auditor may also use tables I and II in figure 450.1 to determine sample size and to evaluate test results for controls that operate more frequently than weekly.[8]

Figure 450.1: Sample Sizes and Acceptable Numbers of Deviations

90 percent confidence level

Table I
Tolerable rate of deviation of 5 percent
(Use for determining sample sizes in all cases)

Sample size	Acceptable number of deviations
45	0
78	1
105	2
132	3
158	4

Table II
Tolerable rate of deviation of 10 percent
(Use for evaluating sample results only if preliminary assessment of control risk is low and deviations exceed those in table I)

Sample size	Acceptable number of deviations
45	1
78	4
105	6
132	8
158	10

The auditor may use table I to determine the sample sizes necessary to support the preliminary assessment of control risk in all cases and to conclude on the effectiveness of the controls. The auditor may use table II to evaluate sample results only when the preliminary assessment of control risk is low and the number of deviations found exceeds the acceptable number of deviations from table I.

[8]Tables I and II assume a population over 5,000 items. If the population is smaller, the auditor may ask the audit sampling specialist to calculate a reduced sample size and to evaluate the results. The effect is generally small unless the sample size per the table is more than 10 percent of the population.

The AICPA has other examples in its guidance, and the table factors are within the range of the AICPA examples and are statistically valid. If an auditor chooses to use factors other than tables I and II, the auditor generally should consult with the audit sampling specialist.

.08 Tables I and II are based on a 90 percent confidence level. The auditor generally uses this confidence level for sampling control tests because the auditor generally obtains additional satisfaction on controls through other audit tests, such as substantive procedures, inquiry, observation, and walk-throughs.

.09 Tables I and II are each based on different tolerable rates of deviation. Table I is based on a tolerable rate of deviation of 5 percent, and table II is based on a tolerable rate of deviation of 10 percent. Each table shows various sample sizes and the maximum number of deviations that may be detected in each statistical sample to rely on the controls at the determined control risk level. See FAM 450.12 through .15 for a discussion of the evaluation of test results.

.10 For financial reporting controls, if the preliminary assessment of control risk is low or moderate, the auditor may use table I to determine sample size. For compliance and operations controls, the auditor may use table I to determine sample size.

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

Evaluate Test Results

.12 Deviations from controls may be caused by factors such as changes in key personnel, significant seasonal fluctuations in the volume of transactions, and human error. If deviations from controls upon which the auditor intends to rely are detected, the auditor should investigate the nature and cause of the deviations. The investigation should include making specific inquiries to understand these matters and their potential consequences. The auditor should evaluate their possible effect on the purpose of the audit procedure and on other areas of the audit. The auditor should also determine whether

- the tests of controls that have been performed provide an appropriate basis for assessing the effectiveness of controls,
- additional tests of controls (such as compensating controls) are necessary, and
- the risks of material misstatement need to be addressed using substantive procedures (AU-C 330.17 and 530.12).

In addition, the auditor should determine whether any misstatements detected from the performance of substantive procedures (see FAM 470, 475, and 480) alter the auditor's judgment as to the effectiveness of related controls.

Financial Reporting Controls

.13 To evaluate sample results, the auditor considers the sample size, the number of deviations, and the confidence level. The auditor may use software (such as IDEA), the tables above, or other tables to evaluate results.[9] If the auditor used table I to determine sample size, and deviations exceed the acceptable number for the sample size, the auditor should follow the guidance below in deciding how to revise the preliminary assessment of control risk.

- **Low control risk.** If the **preliminary assessment of control risk** is low and if deviations are noted that exceed the acceptable number for table I, but not table II, the auditor may reassess control risk as moderate. For example, if the original statistical sample was 45 items, the auditor may reassess control risk as moderate if there is not more than one deviation. If the auditor finds more than one deviation with a sample size of 45 items, the auditor should conclude that the controls being tested are not operating effectively and should reassess control risk as high. Based on this revised assessment, the auditor would change the risk of material misstatement and would reconsider the nature, extent, and timing of substantive procedures.
- **Moderate control risk.** If the **preliminary assessment of control risk** is moderate and if control deviations exceed the acceptable number for table I, the auditor should conclude that control risk is high. The preliminary assessment of control risk is based on the assumption that the controls operate as designed. If the preliminary assessment of control risk is moderate and if control tests indicate that the control is not operating as designed (because deviations exceed the acceptable number in table I), the auditor should conclude that the control is ineffective and revise the control risk assessment to high. Based on the revised assessment of control risk, the auditor would change the assessment of risk of material misstatement and would reconsider the nature, extent, and timing of substantive procedures.

Compliance Controls

.14 If the auditor used table I to determine sample size and deviations exceed the acceptable number for the sample sizes shown in the table, the auditor should conclude that the compliance control is not effective. The auditor also should determine whether any deviations noted ultimately resulted in noncompliance with a significant provision of an applicable budget-related or other law, regulation, contract, or grant agreement. Based on the revised assessment, the auditor would change the risk of noncompliance and would reconsider the nature, extent, and timing of tests of compliance.

Operations Controls

.15 If the auditor used table I to determine sample size and deviations exceed the acceptable number for the sample sizes shown in the table, the auditor should conclude that the operations control is not effective.

[9]Using the AICPA's audit guide, *Audit Sampling*, the auditor calculates the deviation rate and the upper limit at the desired confidence level (usually the same confidence level used to determine sample size). If the upper limit of deviations is less than the tolerable rate of deviation, the results support the control risk assessment. If not, the auditor should increase the assessed control risk when designing substantive procedures.

Other Considerations

.16 The auditor should perform audit procedures, appropriate to the purpose, on each item selected (AU-C 530.09). If the designed audit procedure is not applicable to the selected sample item, the auditor should perform the procedure on a replacement item (AU-C 530.10). An example of when it is necessary to perform the procedure on a replacement item is when a voided check is selected while testing for evidence of payment authorization. If the auditor is satisfied that the check has been properly voided such that it does not constitute a deviation, an appropriately chosen replacement is examined (AU-C 530.A18). Consult with the audit sampling specialist to select replacement items.

.17 If the auditor is unable to apply the designed audit procedures, or suitable alternative procedures, to a selected item, the auditor should treat that item as a deviation from the prescribed control (in the case of tests of controls) or a misstatement (in the case of tests of details; see FAM 480) (AU-C 530.11).

In some circumstances, the auditor may not be able to apply the planned audit procedures to selected sample items because, for example, the entity might not be able to locate supporting documentation. The auditor's treatment of unexamined items will depend on their effect on the auditor's evaluation of the statistical sample. If the auditor's evaluation of the sample results would not be altered by considering those unexamined items to be misstated, it may not be necessary to examine the items, for example, if the aggregate amount of the unexamined items, if treated as misstatements or deviations, would not cause the auditor's assessment of the amount of the misstatement or deviation in the population to exceed tolerable misstatement or tolerable rate of deviation, respectively. However, when this is not the case, the auditor should perform alternative procedures that provide sufficient appropriate audit evidence to form a conclusion about the sample item and use the results of these procedures in assessing the sample results. If alternative procedures cannot be satisfactorily performed in these cases, the auditor is required to treat the items as misstatements or deviations, as appropriate, in evaluating the results of the statistical sample. AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, also requires the auditor to consider whether the reasons for the auditor's inability to examine the items have implications with regard to assessing risks of material misstatement due to fraud, the assessed level of control risk that the auditor expects to be supported, or the degree of reliance on management representations. (AU-C 530.A19)

.18 If, during the testing of sample items, the number of deviations exceeds the acceptable number of deviations in table I or II (as applicable), the auditor should conclude that controls are not operating effectively and decide whether to stop further testing. In making this decision, the auditor should determine whether there are reasons for continuing to test the remaining sample items. For example, the engagement team may need to determine whether additional information (such as an estimate of the population rate of occurrence) is needed to report control deficiencies as described in FAM 580. An interval estimate may help the auditor decide whether the deficiency is a material weakness, other significant deficiency, or other control deficiency.

.19 The auditor should determine which elements of the finding (condition, cause, criteria, possible effect, and recommendation or suggestion) need to be developed. The auditor may decide to include an interval estimate in the report.

The auditor should consult with engagement team management and the audit sampling specialist as applicable in deciding whether to complete the testing of the statistical sample.

.20 If the auditor finds an unacceptable number of deviations in the original statistical sample and the auditor believes the use of a larger sample size may result in an acceptable number of deviations, the auditor generally should consult with the audit sampling specialist before selecting additional sample items. The auditor should not use a revised sample size and evaluate additional sample items based on tables I or II or on the formulas used by certain audit software, such as IDEA.

.21 The auditor should project the results of statistical sampling to the population (AU-C 530.13). The auditor generally should consult with the audit sampling specialist when projecting the rate of sample control deviations to a population for disclosure in a report. If the auditor has used attribute sampling, the auditor should project the deviation rate as a percentage of transactions. If the auditor has used MUS (as part of multipurpose testing), the auditor should project the deviations to the population as a net upper error limit (see FAM 480).

460 – Perform Compliance Tests

.01 The type of provision of a law, regulation, contract, or grant agreement and the assessment of the effectiveness of compliance controls affect the nature and extent of compliance testing. Based on the three categories of provisions (as discussed in FAM 245.06), the auditor should perform the applicable compliance tests discussed below.

Transaction-Based Provisions

.02 To test transaction-based provisions, the auditor should use statistical sampling to select specific transactions for compliance testing. The auditor may use the same statistical sample to perform control tests (e.g., financial reporting, compliance, or operations) and substantive tests, as appropriate (see FAM 430 for discussion of multipurpose testing). If the selection is solely for compliance testing, the auditor generally should use a random attribute sample and follow the guidance in FAM 450. To determine sample size, the auditor should make judgments as to confidence level, tolerable rate of deviation, and expected population deviation rate. The auditor should determine confidence level based on compliance control risk.

For example, if the auditor determines that compliance controls are effective, the auditor may use an 80 percent confidence level, or if ineffective, a 95 percent confidence level. Tolerable rate of deviation is the rate of transactions not in compliance that could exist in a population without causing the auditor to believe the noncompliance rate is too high. GAO auditors generally use a 5 percent tolerable rate of deviation. Since the auditor will assess the impact of all identified noncompliance, many auditors use zero as the expected population deviation rate. Using the above factors yields the sample sizes in table 460.1.

Table 460.1: Compliance Controls, Confidence Level, and Minimum Sample Size

Compliance controls	Confidence level (percentage)	Minimum sample size[a]
Effective	80	32
Not effective	95	58

[a]This statistical sample has a tolerable rate of deviation of 5 percent, expected population deviation rate of zero, and a population of more than 5,000 items. If the population is smaller, the auditor may ask the audit sampling specialist to calculate a reduced sample size and evaluate the results.

Since the auditor usually reports compliance on an entity-wide basis, the auditor may use these sample sizes on an entity-wide basis. Evaluation of test results is discussed in FAM 460.06. The auditor should test the entire statistical sample, even if instances of noncompliance are detected. If the auditor assessed compliance controls on a preliminary basis as effective and the results of testing indicated that this assessment is not appropriate, the auditor generally should consult with the audit sampling specialist to determine the appropriate sample size and selection procedures. If the auditor decides to expand the original statistical sample (instead of reselecting an entirely new sample), the auditor

should select additional items needed to increase the sample size using the random number used to select the original statistical sample. The audit sampling specialist generally should evaluate results when the auditor expands a test.

Quantitative-Based Provisions

.03 Effective compliance controls provide reasonable assurance that the accumulation or summarization of transactional amounts is accurate, complete, and within authorized limits. If compliance controls do not provide such reasonable assurance, the auditor should test the accumulated amount directly for existence, completeness, and summarization. Such tests may be performed on either statistical samples or nonstatistical selections. The auditor should design tests to detect misstatements that exceed either an auditor-determined percentage of the total amount of the accumulated amount or the amount of the restriction stated in the provision, if any. GAO auditors generally use 5 percent of the accumulated amount as the tolerable misstatement for this test.

The auditor may discontinue such tests if significant misstatements in the accumulated amount are noted that would preclude compliance. The test for compliance is the comparison of the accumulated amount with any restrictions on the amount stated in the identified provision. See FAM 245.06 for a description of these restrictions.

.04 If the auditor determines that provisions of applicable budget-related laws and regulations are significant, and if related budget and, consequently, compliance controls are ineffective, the auditor should test the accumulated or summarized amount directly for the following potential misstatements in budget execution information:

- **Occurrence/validity.** Recorded amounts are not valid. (See FAM 395 F for occurrence/validity criteria for obligations, expended authority, and outlays.)
- **Completeness.** Not all amounts that should have been recorded are recorded.
- **Cutoff.** Obligations, expended authority, and outlays are not recorded in the proper period.
- **Accuracy.** Obligations, expended authority, and outlays are not recorded at the proper amounts.
- **Classification.** Obligations, expended authority, and outlays are not recorded in the proper account by program and by object, if applicable, including the proper appropriation year if the account has multiple years. (Examples of program and object classifications are provided in FAM 395 F.)
- **Summarization.** Transactions are not properly summarized to the respective account totals.

An example of audit procedures to test for these misstatements is included in FAM 495 B.

Procedural-Based Provisions

.05 In testing compliance controls relating to a procedural-based provision, the auditor should obtain sufficient evidence to conclude whether the entity performed the procedure and therefore complied with the provision. An example

of a procedural-based provision could be when an entity is required to obtain certain information from grantees. In this case, the auditor would obtain evidence of whether such information was received and therefore whether the entity complied with the provision. If compliance control tests do not provide sufficient evidence to determine compliance, the auditor should perform additional procedures, as necessary, to obtain such evidence.

Evaluating Test Results

.06 For any suspected instances of noncompliance noted in connection with the procedures described above or other audit procedures, the auditor should do the following:

a. Obtain (1) an understanding of the nature of the noncompliance and the circumstances in which it occurred and (2) further information to evaluate the possible effect on the financial statements (AU-C 250.17).

b. Investigate the nature and cause of any deviations or misstatements identified and evaluate their possible effect on the purpose of the audit procedure and on other areas of the audit (AU-C 530.12).

c. Discuss the matter with management (at a level above those involved with the suspected noncompliance, if possible) and, when appropriate, those charged with governance. If management or, as appropriate, those charged with governance do not provide sufficient information that supports that the entity is in compliance with significant provisions of applicable laws, regulations, contracts, and grant agreements, and in the auditor's professional judgment the effect of the suspected noncompliance may be material to the financial statements, the auditor should consider the need to obtain legal advice (AU-C 250.18). If sufficient information about suspected noncompliance cannot be obtained, the auditor should evaluate the effect of the lack of sufficient appropriate audit evidence on the auditor's opinion (AU-C 250.19).

d. If the auditor suspects that management or those charged with governance are involved in noncompliance, communicate the matter to the next higher level of authority at the entity, if it exists. When no higher authority exists, or if the auditor believes that the communication may not be acted upon or is unsure about the person to whom to report, the auditor should consider the need to obtain legal advice (AU-C 250.23).

e. Discuss such suspected instances of noncompliance with OGC and, when appropriate, the Special Investigator Unit and conclude whether noncompliance has occurred and the implications of any noncompliance.

f. Identify the deficiency in compliance controls that did not prevent or detect and correct the noncompliance, if it was not previously identified during compliance control testing.

g. Report any material weaknesses and significant deficiencies in compliance controls and determine the effect, if any, on the report (or opinion) on internal control (see FAM 580).

h. Determine the implications of any instances of noncompliance on the financial statements.

i. Determine the implications of any instances of noncompliance in relation to other aspects of the audit, including the auditor's risk assessment and the reliability of management's representations (AU-C 250.20).

j. Report instances of noncompliance, as appropriate (see FAM 580.91–.99).

470 – Perform Substantive Procedures – Overview

.01 In the internal control phase, for each material line item, account, note disclosure, and class of transactions, the auditor performs a preliminary assessment of control risk and the risk of material misstatement (i.e., combined assessment of control risk and inherent risk) for each identified risk of material misstatement at the assertion level for which inherent risk is more than remote. The auditor's preliminary assessment of control risk is based on the evaluation of the design and implementation of internal control and the results of control tests completed through the internal control phase (see FAM 370). In the testing phase, the auditor plans and performs further audit procedures to respond to the risk of material misstatement.

The preliminary assessment of control risk and the risk of material misstatement should be updated for any control tests completed in the testing phase using audit sampling procedures (see FAM 450). If the auditor plans to perform multipurpose testing (see FAM 430), and thus will not have completed control tests prior to performing substantive procedures, the auditor should plan and perform substantive procedures based on the preliminary assessment of control risk and the risk of material misstatement in the internal control phase.

.02 The auditor should determine the significant assertions, which are those that have one or more identified risks of material misstatement for which inherent risk is more than remote (i.e., assessed at low, moderate, or high) (AU-C 315.12 and .33).[10] An identified risk of material misstatement for which inherent risk is more than remote may relate to more than one assertion, in which case, all the assertions to which such a risk relates are significant assertions. If an assertion does not have an identified risk of material misstatement for which inherent risk is more than remote, then it is not a significant assertion. (AU-C 315.A12)

.03 Based on AU-C 330.18, the auditor should perform substantive procedures for each significant assertion for each material

- line item, such as Fund Balance with Treasury (FBWT);
- account, such as individual FBWT accounts;
- note disclosure, such as disclosures about estimation uncertainty for accounting estimates; and
- class of transactions, such as cash disbursements.

[10]"Significant assertion" as used in the FAM is referred to as relevant assertion in AU-C 315.

In rare circumstances in which the auditor did not identify any significant assertions for a material line item, account, note disclosure, or class of transactions, the auditor should nonetheless perform substantive procedures for that material line item, account, note disclosure, or class of transactions.[11]

Additionally, if the auditor has determined that an identified risk of material misstatement at the assertion level for which inherent risk is more than remote is a **significant risk**, the auditor should perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures (i.e., because controls are not effective), those procedures should include tests of details. (AU-C 330.22)

.04 The auditor's objective in performing substantive procedures is to determine whether significant assertions are materially misstated and to form an opinion about whether the financial statements as a whole are presented fairly, in all material respects, in accordance with U.S. generally accepted accounting principles (U.S. GAAP). To determine if significant assertions are materially misstated, the auditor should perform substantive procedures to address the risks of material misstatement due to fraud or error at the assertion level (see FAM 370).

.05 The auditor's substantive procedures should also include audit procedures related to the financial statement closing processes, such as

- agreeing or reconciling information in the financial statements with the underlying accounting records, including agreeing or reconciling information in the note disclosures, whether such information is obtained from within or outside of the general ledger and subsidiary ledgers (AU-C 330.21a), and
- examining material journal entries and other adjustments made during the course of preparing the financial statements (AU-C 330.21b).

In addition, the auditor should determine whether efficiencies can be achieved by using the concepts of directional testing, as discussed in FAM 470.18 through .24.

.06 As discussed in FAM 265, detection risk is the risk that the auditor will not detect a material misstatement that exists in an assertion. Substantive audit assurance is the complement of detection risk and equals 100 percent minus detection risk. The auditor should determine the substantive audit assurance needed based on the risk of material misstatement. The higher the risk of material misstatement, the more substantive audit assurance the auditor needs.

Audit assurance relates to the entire audit and can be achieved using a combination of control tests and substantive tests. The auditor performs control tests to assess control risk and the risk of material misstatement (combined assessment of inherent risk and control risk). Based on the risk of material misstatement, the auditor determines the substantive audit assurance needed to

[11]Based on AU-C 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, the auditor should perform substantive procedures for classes of transactions, account balances, and disclosures for which there is one or more identified risks of material misstatement for which inherent risk is more than remote. The FAM expands on the AU-C 330 requirement to include performing substantive procedures for all material line items, accounts, note disclosures, and classes of transactions. As a result, the stand-back requirement in AU-C 315.40 does not apply.

achieve the desired level of audit assurance for the entire audit. For a desired audit assurance of 95 percent, GAO auditors generally use the minimum substantive audit assurance indicated in table 470.1 for each risk level.

Table 470.1: Risk of Material Misstatement and Minimum Substantive Audit Assurance

Desired audit assurance of 95 percent	
Risk of material misstatement	**Minimum substantive audit assurance (percentage)**
Low	63
Moderate	86
High	95

Types of Substantive Procedures

.07 There are two types of substantive procedures: (1) substantive analytical procedures and (2) tests of details. To achieve the substantive audit assurance as discussed above, the auditor may use either of these tests or a combination of the two. The type of test to use and the amount of reliance to place on each type of procedure is a matter of the auditor's professional judgment, including considerations of audit effectiveness and efficiency. To determine an appropriate mix of substantive procedures, the auditor may use the audit matrix in table 470.2.

Substantive Analytical Procedures

.08 Substantive analytical procedures involve the auditor comparing a recorded amount with an expectation of that amount and subsequently investigating any significant differences to conclude on the recorded amount. Analytical procedures involve the auditor analyzing plausible relationships among both financial and nonfinancial data. A basic premise is that plausible relationships among data may reasonably exist and continue in the absence of errors, fraud, or changes in circumstances (see AU-C 520).

.09 The auditor may perform substantive analytical procedures at one of three levels for an assertion:

- **Complete.** The auditor relies **solely** on substantive analytical procedures for all of the assurance required from substantive procedures. The procedure is so persuasive that the auditor believes that it is highly likely to detect any aggregate misstatements that exceed performance materiality. Complete assurance from substantive analytical procedures requires procedures that are extremely effective and persuasive to serve as the sole source of audit evidence for achieving the audit objective. This level of effectiveness or persuasiveness is very difficult to achieve when risk of material misstatement is high. Therefore, relying completely on analytical procedures for substantive

audit assurance in these situations is rare, particularly for balance sheet accounts. For significant risks, when the audit approach consists only of substantive tests (i.e., because controls are not effective), the auditor should not place complete reliance on substantive analytical procedures (see FAM 470.03).

- **Partial.** The auditor relies on a **combination** of analytical procedures and tests of details to obtain an appropriate level of substantive audit assurance. For partial assurance, the auditor believes that the analytical procedures more likely than not will detect any aggregate misstatements that exceed performance materiality.
- **None.** The auditor **does not** rely on analytical procedures for audit assurance, and the auditor will obtain substantive audit assurance from tests of details. In this situation, the auditor may perform supplemental analytical procedures to increase understanding of account balances and transactions but not to provide any additional audit assurance. These procedures are similar in scope to those that the auditor performs on an overall basis at the financial statement level (see FAM 520).

.10 To determine whether to perform complete or partial substantive analytical procedures, the auditor should evaluate the effectiveness, or persuasiveness and efficiency, of such procedures. In so doing, the auditor may use the factors discussed in FAM 495 A.

Test of Details

.11 Tests of details are procedures applied to individual items that the auditor selects for testing and include the following:

- **External confirmation** of a transaction or balance (such as accounts receivable or payable) or the related terms (such as the terms of payment) by obtaining and evaluating direct written response to the auditor from a third party (the confirming party), either in paper form or by electronic or other medium (for example, through the auditor's direct access to information held by a third party) (AU-C 505.06). The auditor should consider whether external confirmation procedures are to be performed as substantive audit procedures (AU-C 330.19). The auditor should use external confirmation procedures for accounts receivable, except when one or more of the following is applicable: (a) the overall account balance is immaterial; (b) external confirmation procedures for accounts receivable would be ineffective; or (c) the auditor's assessed level of risk of material misstatement at the assertion level is low, and the other planned substantive procedures address the risk (AU-C 330.20). The auditor should include in the audit documentation the basis for any determination not to use external confirmation procedures for accounts receivable when the account balance is material (AU-C 330.32). See AU-C 505, *External Confirmations*, for procedures related to external confirmations.
- **Observation**, which includes looking at a process or procedure being performed by others (for example, the auditor's observation of inventory counting by the entity's personnel) (AU-C 500.A52).
- **Inspection** by examining an asset (either by being physically present or using remote observation tools) or examining records or documents, whether

internal or external or in paper form, electronic form, or other media (AU-C 500.A51), to determine whether a balance is properly stated, such as examining invoices for expenses and the purchase of inventory and property.

- **Recalculation** by testing the mathematical accuracy of information (AU-C 500.A56). This includes testing the mathematical accuracy of entity records by footing, cross-footing, or recalculating amounts and tracing journal postings, subsidiary ledger balances, and other details to corresponding general ledger accounts. For example, the auditor may recalculate unit cost extensions in an inventory list, foot the list, and trace the total to the general ledger amount. Recalculation may be performed manually or using automated tools and techniques (AU-C 500.A56).

.12 The different types of detail tests are often used in combination to provide sufficient substantive audit assurance about an assertion. For example, to test the valuation or accuracy of accounts receivable, the auditor might confirm balances, recalculate the aging schedule, inspect documents supporting the aging and specific delinquent accounts, and discuss collectability with management. On the other hand, a single detail test might provide audit assurance about more than one of the five assertions. For example, an inspection of inventory may provide evidence about existence, valuation/accuracy, and presentation and disclosure.

.13 The minimum extent of detail testing to be performed is based on the risk of material misstatement and the assurance obtained from substantive analytical procedures, as illustrated in the audit matrix in table 470.2.

Determining Mix of Substantive Procedures

.14 In determining an appropriate mix of substantive analytical procedures and detail tests, the auditor generally should use the audit matrix in table 470.2, which illustrates the integration of such tests for each level of risk of material misstatement, when the auditor is using a desired audit assurance of 95 percent for the entire audit. For example, the auditor should design tests to achieve a substantive audit assurance of 86 percent for an account or line item in which the risk of material misstatement is moderate. To achieve a substantive audit assurance of 86 percent for an account or line item in which partial reliance is placed on analytical procedures, the auditor should design detail tests to achieve a minimum substantive audit assurance of 77 percent.

Table 470.2: Audit Matrix for Desired Audit Assurance of 95 Percent

Risk of material misstatement	Substantive audit assurance (from table 470.1) (percentage)	Substantive audit assurance from analytical procedures[a]	Minimum substantive audit assurance from detail tests (percentage)
Low	63	Complete	0
		Partial	50
		None	63
Moderate	86	Complete	0
		Partial	77
		None	86
High	95	Complete	0
		Partial	92
		None	95

[a]Complete assurance from analytical procedures means that procedures are extremely effective and persuasive to serve as the sole source of audit evidence for achieving the audit objective. This level of effectiveness or persuasiveness is very difficult to achieve when risk of material misstatement is high. Therefore, relying completely on analytical procedures for substantive audit assurance in these situations is rare, particularly for balance sheet accounts. See FAM 470.09.

.15 Additional factors to consider in determining an appropriate mix of substantive analytical procedures and detail tests include the following:

a. **The nature of the assertion being tested.** Analytical procedures are generally more likely to be effective for assertions related to accounts that reflect the audit period's activity, such as accounts included in the statement of net cost, than for accounts related to balance sheet accounts or other cumulative balances.

b. **The nature of the risk of material misstatement.** The auditor should design substantive procedures that address the specific type and level of risk of material misstatement for each assertion. For example, for certain loss claim liabilities, the auditor may design detail tests to search subsequent claim payments for potential liabilities in testing the completeness assertion, while the auditor may use analytical procedures to test the related valuation assertion by evaluating the average amounts per claim. Assertions with higher risk of material misstatement generally require more or higher-quality audit evidence that may not be available from analytical procedures.

c. **The availability of different types of evidence.** Using evidence that can be readily obtained may be more efficient. For example, in federal government audits, the auditor may use budgets and other information in performing analytical procedures.

d. **The quality of the types of evidence available.** The higher the quality of a type of evidence, the greater the level of assurance the auditor may derive from it (see FAM 470.17).

e. **The anticipated effectiveness of substantive analytical procedures.** The auditor should use detail tests if substantive analytical procedures are not expected to be effective.

.16 When determining the types of substantive procedures to use, the auditor should choose the mix of **effective** procedures that are efficient in combination with sampling control tests and compliance tests.

.17 When considering a procedure's relative effectiveness, the auditor should evaluate the expected quality of the evidence. The quality of evidence obtained in substantive procedures depends highly on the circumstances under which it is obtained. Some generalizations about evidence are as follows:

a. Evidence obtained from independent third parties provides a higher level of assurance than evidence obtained from sources in the entity.

b. Evidence obtained directly by the auditor through confirmation, observation, inspection, or recalculation provides a higher level of assurance than evidence obtained indirectly, such as through inquiry.

c. Documentary evidence provides a higher level of assurance than oral representations.

d. Evidence obtained at or near the balance sheet date concerning an asset or liability balance provides a higher level of assurance than evidence obtained before or after the balance sheet date, because the audit risk generally increases with the length of the intervening period.

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

Directional Testing

.18 In planning tests, the auditor may use the relationships between recorded amounts to help achieve efficiencies. For example, in double-entry accounting, a misstatement in one account affects at least one other related account. This relationship allows the auditor to test more than one account with a single test. Additionally, the relationship between budgetary and proprietary accounts may allow for efficiencies in testing, for example, for undelivered orders and delivered orders—unpaid for budgetary accounts and expenses and accounts payable for proprietary accounts.

.19 As stated, in double-entry accounting, a misstatement in one account affects at least one other related account. For example, a misstatement of accrued payroll typically results in a misstatement of payroll expense. In this example, substantive procedures performed on accrued payroll usually will detect any misstatements in both accrued payroll and payroll expense. In designing substantive procedures after considering risk of material misstatement and developing an understanding of each related account, the auditor should determine the effect of tests on related accounts. For example, a test of revenue for completeness may provide substantive evidence about the completeness of accounts receivable.

Where the entity uses double-entry accounting, the auditor may (1) design an overall audit strategy that tests certain accounts substantively for either existence or completeness (the two assertions most affected by testing related accounts)

and (2) rely on such tests to detect misstatements in the related accounts. For example, the auditor may test (1) assets and expenses directly for existence and (2) liabilities, equity, and revenue for completeness, thereby indirectly testing the related accounts for existence or completeness, as applicable. This logic is called a directional testing approach.

.20 In some instances, the auditor may supplement a directional testing approach to address a specific risk of material misstatement. For example, if cutoff is a significant risk, the auditor may test both existence and completeness assertions in a test of cutoff as of the balance sheet date. During initial financial statement audits, the auditor generally should test both existence and completeness directly, when those assertions are significant, because the cumulative knowledge about the interaction of accounts may be limited.

.21 The audit assurance that can be obtained from directional testing is diminished if related accounts are not also tested (e.g., balance sheet-only audits or audits of cash-basis statements). In these instances, the auditor should test both existence and completeness directly when those assertions are significant.

.22 The auditor may combine the testing of budgetary and proprietary accounts when appropriate. For example, the auditor may combine tests of outlays on the statement of budgetary resources with tests of cash disbursements used to test net costs.

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

.24 Also, if (1) relevant budget restrictions relate to significant quantitative-based provisions of laws and regulations and (2) budget controls are not effective, the auditor should test the accumulated or summarized information directly (see FAM 460.03–.04).

475 – Perform Substantive Analytical Procedures

.01 This FAM section provides guidance on the application of substantive analytical procedures. These procedures consist of evaluations of financial information made through analysis of plausible relationships among both financial and nonfinancial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts (AU-C 520.04).

The auditor develops an expectation or estimate of the recorded amount based on an analysis and understanding of relationships between the recorded amounts and other data. This expectation is then used to form a conclusion on the recorded amount. A basic premise underlying analytical procedures is that plausible relationships among data may reasonably be expected to exist and continue unless conditions have changed or the data are misstated. The reasons that make relationships plausible are an important consideration because data sometimes appears to be related when it is not, which may lead the auditor to erroneous conclusions. In addition, the presence of an unexpected relationship may provide important evidence when appropriately scrutinized (AU-C 520.A6). For further information, refer to AU-C 520 or the AICPA's audit guide, *Analytical Procedures*.

.02 Scanning account detail and recalculation are two other audit procedures related to substantive analytical procedures. Scanning consists of searching for unusual items in the detail of account balances. Scanning is an appropriate tool for investigating the cause of a significant fluctuation, but it is not a substantive analytical procedure on its own. The auditor should investigate unusual items identified through scanning to obtain substantive audit assurance about the cause of the fluctuation. For example, the auditor identifies an unusual fluctuation in the property balance when performing other substantive procedures. In scanning a detail listing of vehicles, the auditor may find an auto valued at $600,000, which appears unusually high. Further investigation finds that the decimal point was misplaced when the data was entered, and the vehicle should be recorded at $6,000.

The auditor may also independently calculate an estimate of an account balance, which is sometimes referred to as recalculation or an overall test of reasonableness. These recalculations are considered substantive analytical procedures. When making recalculations, the auditor should assess the reliability of the data used and should follow the steps used for performing substantive analytical procedures. An example is recalculating the amount of depreciation expense on equipment using the accounting method, useful life, and date an asset was placed into service.

.03 The risk of forming the incorrect conclusion on the account balance tested may be higher for substantive analytical procedures than for detail tests because of the extensive use of the auditor's professional judgment. Accordingly, quality control is of critical importance. To help maintain quality in these procedures, experienced engagement team personnel usually perform, or closely supervise and review, the assessment of the reliance to place on procedures, design of procedures, and formulation of conclusions as a result of procedures.

Designing and Performing Substantive Analytical Procedures

.04 When determining whether performing substantive analytical procedures will be effective and efficient as a substantive test, see FAM 495 A for guidance. In designing and performing substantive analytical procedures, as discussed in AU-C 520.05, the auditor should do the following:

a. Determine the suitability of particular substantive analytical procedures for given assertions, taking into account the risks of material misstatement and tests of details, if any, for these assertions.

b. Evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking into account the source, comparability, and nature and relevance of information available and controls over preparation.

c. Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise (taking into account whether substantive analytical procedures are to be performed alone or in combination with tests of details) to identify a misstatement that individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.

d. Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation and compare the recorded amounts, or ratios developed from recorded amounts, with the expectations. This is also referred to as the limit. The determination of the limit is a matter of the auditor's judgment, although some guidelines are provided in FAM 475.05.

e. Obtain explanations from management for differences that exceed the limit, since such differences are significant. Obtain appropriate audit evidence to corroborate management's explanations for significant differences (AU-C 520.07). This is discussed further in FAM 475.08 through .11.

f. Determine whether the explanations and corroborating evidence provide sufficient evidence for the desired level of substantive audit assurance. If unable to obtain a sufficient level of substantive audit assurance from substantive analytical procedures, the auditor should perform additional procedures, as discussed in FAM 475.12 through .17, and evaluate whether the difference represents a misstatement (AU-C 520.07).

g. Evaluate whether the assessment of risk of material misstatement remains appropriate, particularly in light of any misstatements identified. Revise the assessment of risk of material misstatement, if necessary, and consider the effects on the extent of detail tests.

h. Document on the summary of uncorrected misstatements the amount of any misstatements detected by substantive analytical procedures and their estimated effects (see FAM 540). Note that the amount of any misstatement does not include the amount of the limit, which is the amount of the difference between the recorded amount and the expectation that does not require explanation.

i. Conclude on the reasonableness of the recorded amount.

j. Include documentation of work performed, results, and conclusions. See FAM 490.

The auditor may consider testing the operating effectiveness of controls, if any, over the entity's preparation of information used by the auditor in performing substantive analytical procedures. When such controls are effective, the auditor may have greater confidence in the reliability of the information and therefore in the results of analytical procedures (AU-C 520.A19).

Establishing the Limit

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

- **Complete reliance.**[12] The limit is 20 percent or less of performance materiality.
- **Partial reliance.** The limit is 30 percent or less of performance materiality.
- **No reliance.** Substantive analytical procedures are not needed.

Auditors should document the basis for the limit used.

Investigating Significant Differences

Causes of Significant Differences

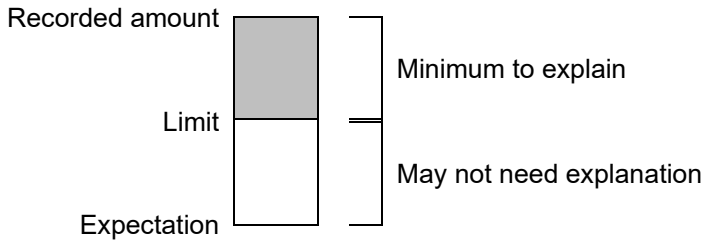
.06 Differences between the expectation and the recorded amount relate to either factors not included in the model (such as specific unusual transactions or changes in accounting policies), a lack of preciseness of the model, or misstatements (either errors or fraud). The auditor's objective in investigating significant differences is to determine whether they represent misstatements or one of the other factors.

Amount of Difference to Be Explained

.07 When obtaining explanations, the auditor should discuss with management the model and assumptions used to develop the expectation. Management will then be in a better position to provide the auditor with a relevant explanation. If the amount of the difference exceeds the limit, the auditor should ask management to provide an explanation for the entire difference between the recorded amount and the expectation. However, the auditor may decide to stop if the explanation covers the portion of the difference that exceeds the limit (see fig. 475.1). If the difference does not exceed the limit, an explanation is not required. The auditor should identify and corroborate all significant factors that cause the expectation to differ from the actual amount, regardless of whether the factors increase or decrease the difference.

[12]For significant risks, when the approach consists only of substantive procedures (i.e., because controls are not effective), the auditor should not place complete reliance on substantive analytical procedures (see FAM 470.03).

Figure 475.1: Explanations When Recorded Amount Exceeds Limit



Corroboration of Explanations

.08 The relevance and reliability of corroborating evidence may vary significantly. Therefore, the extent of corroboration of explanations is left to the auditor's professional judgment. Corroboration may consist of examining supporting documentation or corroborating explanations from personnel in the accounting department and personnel in the appropriate operating department knowledgeable about the entity's operations.

The auditor should quantify and address the direction and magnitude of the event that caused the fluctuation and corroborate explanations received. The auditor should determine whether sufficient corroborating evidence has been obtained based on the guidelines for complete and partial assurance discussed in FAM 470.09. In evaluating explanations, the auditor should also determine whether the difference is caused by error or fraud.

Example of an Adequate Explanation for a Significant Fluctuation

.09 Assume that the auditor assessed performance materiality to be $25 million. Additionally, assume that the auditor has determined, after assessing the risk of material misstatement, to perform a substantive analytical procedure with a limit of $5 million. The auditor estimated interest expense at $80 million by multiplying the average loan balance of $1 billion by an average interest rate of 8 percent. Both of these averages were calculated using a simple average of beginning-of-year and end-of-year amounts. The recorded amount of interest expense, $95 million, is higher than the estimated amount by $15 million and exceeds the limit by $10 million.

.10 An explanation from management that "we borrowed more money this year and interest rates are higher than last year" would not be adequate, as it explains why interest is likely to be higher but not how much higher (it corroborates direction, not amount). The auditor should ask management to quantify the explanation by indicating when interest rates changed and when amounts borrowed changed. The auditor should then corroborate the information provided.

.11 An example of an adequate explanation follows.

Management determined that interest rates increased during the year and then fell. The rates were calculated to average 9 percent based on the attached monthly weighted average. Additionally, $100 million was borrowed and repaid during the year, and the additional borrowings were outstanding for 6 months. Therefore, the average loan balance was actually $50 million higher and the average interest rate was 1 percent higher than the figures used in the original estimate.

Therefore, 97 percent of the interest expense in excess of the expectation can be explained as follows (in thousands):

$1,000,000	X	1%	=	$10,000
50,000	X	9%	=	4,500
Amount of difference explained				$14,500

The auditor examined correspondence from lenders and loan statements to corroborate these explanations. The auditor was satisfied that these covered the significant factors and that it was not necessary to obtain an explanation for the remaining $.5 million, or 3 percent difference. The auditor concluded that interest expense is not misstated and no amounts are posted to the Summary of Uncorrected Misstatements.

Course of Action in the Event of Inadequate Explanations or Corroborating Evidence

.12 If management's explanation and corroborating evidence do not adequately explain the fluctuation sufficiently to provide either complete or partial assurance, the auditor should perform additional substantive procedures or treat the difference as a misstatement. These procedures may consist of

- increasing the effectiveness of the substantive analytical procedures by making the expectation more precise to obtain the desired assurance or
- performing tests of details and placing no reliance on the ineffective substantive analytical procedures.

.13 The auditor should determine the effectiveness and efficiency of the above options. Deciding whether to perform additional substantive procedures is a matter of the auditor's professional judgment. The auditor should perform additional procedures to provide adequate assurance that aggregate misstatements that exceed performance materiality have been identified.

.14 To increase the persuasiveness or effectiveness of an analytical procedure, the auditor may make the expectation more precise by

- building a more sophisticated model by identifying more key factors and relationships,
- disaggregating the data (such as using monthly instead of annual data),[13] or
- using more reliable data or obtaining greater confidence in the data's reliability by corroborating the data to a greater extent.

Measuring the precision of the expectation and the impact of changing each of these factors on the procedure's effectiveness is difficult. The auditor may consult with an expert in this field.

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

Performing Supplemental Analytical Procedures

.15 If detail tests are used to test the account balance because adequate explanations cannot be obtained or corroborated, the auditor still should obtain an overall understanding of the current-year financial statements when applying overall analytical procedures at the financial statement level. See FAM 520.

.16 Additionally, if analytical procedures originally performed as a substantive test do not provide the necessary assurance, the auditor may use those procedures to supplement an understanding of the account balances or transactions after performing detail tests.

.17 When the auditor places no reliance on substantive analytical procedures, all assurance is provided by detail tests. In this situation, the auditor may use supplemental analytical procedures to increase the auditor's understanding of the account balances and transactions after performing the detail tests. When using supplemental analytical procedures, the auditor uses professional judgment to determine which fluctuations to obtain explanations for and which explanations to corroborate.

480 – Perform Substantive Detail Tests

Population to Be Tested

.01 In defining the population, the auditor should identify the whole set of items on which the auditor needs to reach a conclusion and from which the audit sample will be drawn. This includes

- describing the population and its source,
- conducting data reliability tests to determine whether the population is complete and valid,
- determining the evidence available to be tested, and
- defining the period covered by the test.

When conducting data reliability tests, the auditor should analyze the population for characteristics such as large or unusual balances, duplicate items, and abnormal balances. The auditor may also test the effectiveness of the entity's controls over the source of the population, as well as the method of extraction and parameters used. This may include testing relevant general controls and application controls over the source of the population (e.g., the information system from which the population is extracted). See FAM 300 for detailed guidance on performing tests of controls, including IS controls.

.02 In designing detail tests, the assertion tested affects the choice of the population (an account balance or a portion of an account balance) from which items are selected. For example, the existence assertion deals with whether recorded assets or liabilities exist as of a given date and whether recorded transactions have occurred during a given period. To detail test the existence assertion, the auditor should test the recorded account balance by

- selecting items from those that compose the account balance and
- testing those items to evaluate whether including them in the account balance is proper.

For example, to test an expense account for existence, the auditor may select from a detailed general ledger individual expense amounts included in the balance and then examine invoices that support the expense amounts. It would be inappropriate to select invoices directly and then trace invoice amounts to inclusion in the general ledger balance.

.03 For the **existence** assertion, the auditor should determine if the population agrees with or is reconciled to the recorded amount of the account balance being tested. The auditor should test reconciling items, if any. If this is not done, the auditor can conclude only on the population tested and not on the recorded population. Conversely, the **completeness** assertion deals with whether all transactions and accounts that are expected to be in the financial statements are included. To detail test the completeness assertion, the auditor should select from an independent population of items that are expected to be recorded in the account. The auditor should (1) select items from a source that is likely to contain all the items that are expected to be recorded and (2) determine whether they are included in the recorded balance.

For example, to test completeness of recorded revenue, the auditor may select shipments from a shipping log (which is believed to be reasonably complete), trace them to recorded revenue amounts, and then test whether the summarization of those amounts was included in the general ledger revenue balance. To test completeness of recorded accounts payable, the auditor may select payments made subsequent to year-end plus invoices on hand but not yet paid. The auditor may then trace transactions for which the receipt of goods or services occurred before year-end for inclusion in year-end accounts payable. For those transactions where the receipt occurred after year-end, the auditor should test for exclusion from accounts payable.

Selection Methods for Detail Tests

.04 The auditor may apply detail tests to any of the following:

- all items composing the population,
- a nonstatistical selection of items, or
- an audit sample of items composing the population.

Flowchart 1 in FAM 495 D illustrates the process of deciding the selection method.

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

.06 Detail testing of **a nonstatistical selection** is appropriate where the auditor knows enough about the population to identify a relatively small number of items of interest, usually because they are likely to be misstated or otherwise have a high risk of material misstatement.

While the dollar amount is frequently the characteristic that indicates that an item is of interest, other relevant characteristics might include an unusual nature (such as an item identified on an exception report); an association with certain entities (such as balances due from high-risk, financially troubled entities); or a relationship to a particular period or event (such as transactions immediately before and after the year-end).

The auditor should evaluate the effects of any misstatements found in the nonstatistical selection. However, unlike audit sampling, the results of procedures applied to items selected under nonstatistical selection apply only to the selected items. **It is incorrect for the auditor to project the results to the portion of the population that was not tested**. Accordingly, the auditor should apply appropriate substantive analytical procedures, other substantive procedures, or both to the remaining items, unless those items are immaterial in total or the auditor has already obtained enough assurance that there is a low risk of material misstatement in the untested population through other audit procedures.

.07 Detail testing of **an audit sample of items composing the population** is necessary when the auditor cannot efficiently obtain sufficient assurance about the population from nonstatistical selections. AU-C 530, *Audit Sampling*, indicates that audit samples may be either statistical or nonstatistical.

The auditor should select items for the audit sample in such a way that the auditor can reasonably expect the sample to be representative of the relevant population and likely to provide the auditor with a reasonable basis for conclusions about the population (AU-C 530.08). The auditor should select the audit sample so that each item in the population has an opportunity to be selected. In random sampling, each item has an equal chance of selection. For MUS, each monetary unit (dollar) has an equal chance of selection. For classical variables sampling, each item in a stratum has an equal chance of selection. Based on the results of procedures performed on the audit sample, the auditor should conclude on the entire population.

.08 The auditor may use a nonstatistical selection for part of the population and an audit sample for the remainder of the population. For example, the auditor may make a nonstatistical selection of all inventory items with a book amount greater than $10 million, and select an audit sample for the remainder of the population. The auditor is able to conclude on the entire population by combining the results of the nonstatistical selection with the results of the audit sample.

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

Audit Sampling

.10 The following paragraphs provide an overview of audit sampling, primarily with respect to the existence and valuation assertions. Similar concepts and methods apply to the completeness assertion, except that the population to be tested differs, as discussed in FAM 480.01 through .03.

.11 The auditor generally should consult with the audit sampling specialist when using sampling, including selection of audit sampling methods, selection of sample items, and evaluation of audit sample results.

.12 In **statistical sampling**, the auditor uses probability theory to determine sample size, select the sample, and evaluate the results to reach a conclusion about the population. Statistical sampling permits the auditor to objectively determine sample size (based on subjective decisions about risk and materiality), objectively select the sample items, and objectively evaluate the results. Thus, by using statistical sampling, the auditor determines objectively whether enough work has been performed. When using statistical sampling, the auditor should determine a sample size sufficient to reduce sampling risk to an acceptably low level (AU-C 530.07).

Because of these advantages, when an audit sample is necessary, the auditor generally should use statistical sampling. Software such as IDEA allows the auditor to quickly perform the calculations necessary for statistical sampling.

.13 In **nonstatistical sampling**, the auditor considers statistical concepts but does not explicitly use them to determine sample size, select the sample,[14] or evaluate results. Unlike statistical sampling, which allows the auditor to objectively evaluate sample results, the auditor using nonstatistical sampling will only be able to subjectively evaluate sample results, such as making a judgment about whether the potential misstatement in the population could be material.

The decision whether to use a statistical or nonstatistical sampling approach is a matter of professional judgment. AICPA guidance states that this choice is often a cost-benefit consideration;[15] however, sample size is not a valid criterion to use in deciding between statistical and nonstatistical sampling approaches. An auditor who applies nonstatistical sampling exercises professional judgment to relate the same factors used in statistical sampling in determining the appropriate sample size. Ordinarily, this would result in a sample size comparable with the sample size resulting from an efficient and effectively designed statistical sample, considering the same sampling parameters (AU-C 530.A14).

.14 In audit sampling, the auditor should select the sample from all the items that compose the population so that each item has an opportunity for selection. In statistical sampling, the auditor can determine the probability of selection. For example, the auditor may select sample items from a list of all accounts receivable balances that is reconciled to the related general ledger account balances. Selecting sample items from file drawers is not a valid selection method for any type of audit sampling, unless the auditor has determined that the file drawers contain all items composing the population.

.15 For statistical samples, the auditor generally should select sample items using either random or MUS methods. The auditor may use computer software to select the statistical samples.

.16 Sample size is a function of the size of the population, the auditor's assessment of the risk of material misstatement, desired confidence level (based on the amount of substantive audit assurance that the auditor requires from detail tests, tolerable misstatement, expected misstatement in the population, and other factors discussed in FAM 230.13), and the sample selection method (AU-C 530.A13).

.17 Once the auditor decides that a statistical sample is necessary, the choice of sampling method is a matter of professional judgment, in consultation with the audit sampling specialist as applicable, about the most efficient method for

[14]The principal techniques of selecting a nonstatistical sample are the use of random selection and haphazard selection to select sample items (AU-C 530.A17). Since a haphazard sample is not the same as a statistical sample, the auditor using a haphazard sample cannot calculate precision at a given confidence level. However, AICPA guidance indicates that the auditor may use the haphazard sample to make a judgment of what a statistical sample might have shown. For example, the auditor may use the haphazard sample to make a judgment as to the misstatement in areas that are not very significant. Even though the judgment will not be a statistical projection, it may assist the auditor in determining whether the possible misstatement could be material.

[15]For example, it may not be efficient to use statistical sampling when the population is not in electronic format. Another example of when it may be difficult to apply statistical sampling is when the auditor plans to use audit sampling to test a physical inventory count and the entity does not maintain perpetual inventory records. Because either statistical or nonstatistical sampling can provide sufficient audit evidence, the auditor chooses between them after considering their relative efficiency and effectiveness in the circumstances.

achieving the audit objectives. Statistical sampling methods available for substantive procedures are

- MUS (see FAM 480.21–.22),
- classical variables sampling (see FAM 480.27–.28), and
- classical probability proportional to size (PPS) sampling—evaluating a PPS sample using a classical variables sampling approach (see FAM 480.29–.30).

The auditor may use attribute sampling for tests of controls and for tests of compliance with significant provisions of applicable laws, regulations, contracts, and grant agreements. For example, the auditor may select an MUS sample of expenditure transactions for testing and include testing the sample for approvals, for entry into the general ledger, and for compliance with applicable provisions of the Prompt Payment Act. It should be noted that multipurpose tests may not be efficient if they are conducted during the first 2 years of a new audit, as the auditor may not be as aware of the operating effectiveness of the controls in place at an entity in a new audit and the rate of deviation may be higher than expected. In order to use MUS for a multipurpose test, there should be at least 45 unique transactions selected to meet the minimum control sample size requirements in FAM 450.

Classical variables sampling often results in smaller sample sizes. Multistage samples may reduce time and travel costs. The auditor generally should consult with the audit sampling specialist before using this sampling method.

.18 Each of these statistical sampling methods yields a projected (likely) misstatement and an upper limit at the desired confidence level. In addition, classical PPS and classical variables sampling both yield a two-sided confidence interval (MUS yields an upper limit). The auditor should choose the appropriate method based on the test objectives and efficiency.

.19 When deciding the statistical sampling method, the auditor should determine whether the monetary amounts of the individual items composing the population are available (for example, on a detail listing or in a computer file); the expected amount of misstatements; and the relative efficiency of each appropriate sampling method. Flowchart 2 in FAM 495 D summarizes the process for choosing the statistical sampling method once the auditor has decided that a statistical sample is necessary. The subsequent pages of the flowchart indicate the steps that the auditor generally should perform for each statistical sampling method. Example audit documentation for attribute sampling, MUS, and classical variables sampling can also be found in FAM 495 D.

.20 If the dollar amounts of the individual items composing the population are known, the auditor should use MUS, classical PPS, or classical variables sampling. If dollar amounts of individual items are not known, see FAM 480.31 through .33.

Statistical Sample Selection

MUS

.21 MUS is a type of statistical sampling that the auditor generally should use when

- the monetary amounts of individual items in the population are known,

- the primary objective is to test for overstatement of the population (see below for testing a population related to the line item),
- the auditor expects that the total monetary amount of misstatement in the population is not large,[16] and
- the amount of misstatement in an individual item cannot exceed the selected amount.[17]

MUS works best in populations where the total misstatement is not large and where the objective is to test for overstatement of a population. When the objective is to test for understatement of a line item, the auditor often is able to define a related population to test for overstatement. For example, to test for understatement of accounts payable, the auditor may select an MUS sample of subsequent disbursements. See also FAM 480.31–.33.

.22 When the total misstatement in the population is not large, MUS will yield the smallest sample size for a given population, tolerable misstatement, and desired confidence level when all statistical sampling methods are considered. If the auditor expects that the population contains a large amount of misstatement, the auditor generally should use classical variables sampling (see FAM 480.27–.28).

Computation of MUS Size

.23 When the auditor uses IDEA to calculate the MUS size, the inputs are

- total value of sample population,
- confidence level,
- tolerable error (tolerable misstatement), and
- expected error (expected misstatement).

.24 The auditor should perform audit procedures, appropriate to the purpose, on each item selected (AU-C 530.09). If the audit procedure is not applicable to the selected item, the auditor should perform the procedure on a replacement item (AU-C 530.10).

.25 If the auditor is unable to apply the designed audit procedures, or suitable alternative procedures, to a selected item, the auditor should treat that item as a deviation from the prescribed control (in the case of tests of controls; see

[16]This expectation affects the efficiency of the sample, not its effectiveness. GAO auditors who use IDEA to calculate sample size (based on the hypergeometric probability distribution) use classical variables sampling when they expect that more than 30 percent of the sampling units contain misstatements. When GAO auditors expect that 10 percent or fewer of the sampling units contain misstatements, GAO auditors use MUS. When GAO auditors expect that 10 to 30 percent of the sampling units contain misstatements, they consult with the audit sampling specialist. The auditor, in consultation with the audit sampling specialist, generally should determine whether to use classical PPS to evaluate the sample to obtain a smaller precision, if a large misstatement rate is found. Other auditors, in consultation with their audit sampling specialists as applicable, may use different rules in deciding when to use MUS versus classical variables sampling.

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

FAM 450) or a misstatement (in the case of tests of details) (AU-C 530.11). If this is the case, see further explanation at FAM 450.17.

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

Classical Variables Sampling

.27 Classical variables sampling is a type of statistical sampling that may be used when the auditor expects that one or more conditions exist in the population, such as

- the dollar amount of misstatement in the population is large (see footnote 3),
- individual misstatements may exceed the selected amount of sampling units,
- significant understatements cannot be identified using other tests,
- there are no book amounts for each sampling unit, or
- the auditor cannot add the dollar amounts in the population (see flowchart 2 in FAM 495 D).

.28 Classical variables sampling is useful because it frequently results in smaller sample sizes in higher misstatement situations than those that would be obtained using MUS. Because applying this method is somewhat complex, the auditor generally should consult with the audit sampling specialist before using it. Both this method and classical PPS sampling discussed below require knowledge of the population to determine sample size. In many audits, the auditor learns about the population over several audits and may use this knowledge to refine the sampling methodologies to improve efficiency.

Classical PPS Sampling

.29 Classical PPS sampling is a type of statistical sampling that the auditor generally should use when testing for overstatement of the defined population and expecting a large misstatement rate. Since there is no exact way to determine sample size, the auditor uses MUS to calculate sample size (proportional to size). However, since classical PPS sampling is used when there are large misstatement rates, the auditor should use a conservative (high) estimate of the expected misstatement to avoid needing to subsequently expand the sample size to obtain a sufficient sample size.

.30 Classical PPS sampling yields a valid measure of projected misstatement and precision and is easier to design and evaluate than classical variables sampling. Thus, in higher misstatement situations, the auditor may choose to use classical PPS sampling if there are no reasons for using classical variables sampling other than an expected high misstatement rate.

Sampling When Dollar Amounts Are Not Known

.31 The auditor cannot use MUS if the dollar amounts of individual items in the population are not known. The auditor may use classical variables sampling, but this method has some difficulties. There is no way to accurately calculate the

sample size without the individual dollar amounts, and the method is inefficient unless the auditor finds a large misstatement rate. Auditors usually encounter lack of individual dollar amounts when testing the completeness assertion and selecting from a population independent of the population being tested, such as a shipment from a shipping log (see FAM 480.01–.03). One approach may be for the auditor to select a random or systematic sample of the individual items. For example, the auditor may randomly select items from a shipping log to test the completeness/cutoff assertion for revenue and accounts receivable that shipments have been billed in the proper period.

.32 For this type of test, the sample size may be approximated from the total (dollar) amount of either the population from which the auditor is sampling (the total dollars of the shipping log if the log has amounts), or the amount of the population that the auditor is testing (the total recorded revenue). Because this method is less efficient than MUS, the auditor generally should use a preliminary estimate of sample size that exceeds the sample size that would result from using MUS, for example, at least a 25 percent increase in sample size.[18]

.33 The auditor generally should consult with the audit sampling specialist to determine whether to use classical variables sampling and to perform the evaluation. In using attribute sampling for substantive tests, the auditor generally should use the upper limit of the misstatement rate to make a conservative estimate of the dollar amount of misstatement in the population. If the upper limit is less than materiality, the auditor has evidence that the population is free of material misstatement.

Evaluation of Sample Results

.34 Evaluation of sampling results, including sampling risk (AU-C 530.14), should involve the following:

- projecting the results of the statistical sample to the population (AU-C 530.13) (for nonstatistical samples, making a judgment about the potential effect of any deviations or misstatements in the population);
- calculating either (1) the upper limit on misstatement in the population or (2) an interval estimate of misstatement or of the population audited value, at the desired confidence level (for nonstatistical samples, considering the risk of further misstatement);
- determining any qualitative aspects of the deviations/misstatements;
- bringing deviations/misstatements to management's attention;
- asking management to correct factual misstatements;
- investigating the nature and cause of any deviations or misstatements identified and evaluating their possible effect on the purpose of the audit procedure and on other areas of the audit (AU-C 530.12);
- concluding as to whether the population is free from material misstatement, after management's adjustments, if any; and

[18]The 25 percent is a rough estimate that is used because the auditor cannot calculate the correct sample size.

- evaluating the effect of misstatements on the financial statements as a whole.

The auditor usually completes the first two steps above with software such as IDEA. The auditor generally should perform the evaluation in consultation with the audit sampling specialist.

.35 The effects of any misstatements detected in a statistical sample are projected to the population. The auditor should project all misstatements unless **highly persuasive evidence** is obtained that a misstatement is not representative of the entire population. If the evidence is highly persuasive that a misstatement is not representative of the population, the auditor should

- perform procedures to test that the same type of misstatement does not exist elsewhere in the population;
- evaluate the misstatement that is not representative;
- evaluate the statistical sample, excluding the misstatement that is not representative; and
- obtain the approval of the audit director that the evidence is highly persuasive.

The projected misstatement amount is included in the summary of uncorrected misstatements, the evaluation of which is discussed in FAM 540.

.36 At the conclusion of the test, the auditor also should determine whether the assessment of risk of material misstatement remains appropriate, particularly in light of any misstatements identified. If the preliminary risk of material misstatement assessment was not appropriate, the auditor should determine whether the extent of substantive procedures is adequate. The auditor's determination must be provided to the reviewer in a timely manner to allow any issues to be promptly identified and resolved.

.37 When understated amounts are detected in any statistical sample designed primarily to test the existence assertion (i.e., designed to test primarily for overstatement), the auditor generally should consult with the audit sampling specialist in evaluating the sample results.

Calculating the Projected Misstatement for MUS

.38 If the auditor does not use software to evaluate statistical sample results, the auditor should calculate projected misstatement as follows. If the sample item has a recorded amount that equals or exceeds the sampling interval, the projected misstatement is the actual amount of the misstatement identified for that item. For any other misstatement detected, the projected misstatement is calculated by

- dividing the amount of misstatement by the recorded amount of the sample item and
- multiplying the result by the amount of the sampling interval.

The sum of all projected misstatements represents the aggregate projected misstatement for the statistical sample. For example, assume the following two misstatements are detected in a statistical sample for which the sampling interval is $300,000: (1) a $50,000 misstatement detected in a $500,000 item (which exceeds the amount of the sampling interval) results in a projected misstatement

of $50,000 and (2) a $100 misstatement in a $1,000 sample item represents a 10 percent misstatement, which results in a projected misstatement of $30,000 (10 percent of the $300,000 sampling interval). In this example, the aggregate projected misstatement is $80,000.

Evaluating a MUS as a Classical PPS Sample

.39 If a MUS results in a large number of misstatements, it is likely that the evaluation based on using the calculating method illustrated above would indicate that the upper limit of misstatement in the population exceeds materiality (IDEA indicates the number of misstatements that would yield acceptable results). However, if there are a large number of misstatements,[19] the auditor, in consultation with the audit sampling specialist, generally should evaluate the sample using classical PPS sampling. This evaluation is complex and cannot be done directly using IDEA.

Evaluating the Results of a Classical Variables Sample

.40 The auditor generally should consult with the audit sampling specialist in evaluating the results of a classical variables sample.

Evaluating the Results of Other Samples

.41 When the auditor detects misstatements in an audit sample for which guidance on evaluation is not described above, the auditor generally should consult with the audit sampling specialist.

Effects of Misstatements on the Financial Statements

.42 The auditor should evaluate the quantitative and qualitative effects of all misstatements detected in the audit in relation to the financial statements as a whole. FAM 540 and 545 provide guidance on this evaluation.

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

490 – Documentation

.01 The auditor should include in the audit documentation the

a. overall responses to address the risks of material misstatement at the financial statement level and the nature, extent, and timing of further audit procedures performed;

b. the linkage of those procedures with the risks of material misstatement at the assertion level; and

c. the results of the audit procedures, including the conclusions when such conclusions are not otherwise clear (AU-C 330.30).

The auditor should also specifically identify the procedures used to obtain substantive audit assurance for an account balance, for example, when the auditor relies on detail tests for complete substantive audit assurance and performs supplemental analytical procedures to increase the auditor's understanding of the account balances and transactions. The auditor may document the procedures performed, results, and conclusions in summary memos by cycle area.

.02 As discussed in FAM 290, the auditor should prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the significant findings or issues arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions. Some examples of circumstances in which it is appropriate to prepare audit documentation relating to the exercise of professional judgment include, when the findings, issues, and judgments are significant (AU-C 230.A12):

- the rationale for the auditor's conclusion when a requirement provides that the auditor should consider certain information or factors, and that consideration is significant in the context of the particular engagement;
- the basis for the auditor's conclusion on the reasonableness of areas of subjective judgments made by management;
- the basis for the auditor's evaluation of whether an accounting estimate and related note disclosures are reasonable in the context of the applicable financial reporting framework (generally U.S. GAAP) or are misstated (see FAM 490.06f); and
- the basis for the auditor's conclusions about the authenticity of a document when further investigation is undertaken in response to conditions identified during the audit that caused the auditor to believe that the document may not be authentic.

.03 In order to focus on key matters and identify significant exceptions, the auditor generally should document in the planning audit documentation the audit objectives, procedures to be performed, possible exceptions, and why they may be important.

.04 The auditor also should document, usually in the applicable audit plan with the audit procedures, whether a selection is intended to be a

- statistical sample (representative of, and statistically projectable to, the population),
- nonstatistical sample (representative of, but not statistically projectable to, the population), or
- nonstatistical selection (not representative of, and not projectable to, the population).

If it is a nonstatistical selection, the auditor should document the assessment of the risk of material misstatement for the items not tested as part of the selection and the basis for concluding that enough work has been done to obtain sufficient assurance that the items not tested are free from aggregate material misstatement.

.05 As audit work is performed, the auditor may become aware of possible material weaknesses, significant deficiencies, other control deficiencies, identified or suspected noncompliance, or other matters. The auditor should document and communicate these issues, as described in FAM 580 and 590.

.06 The auditor should also document the specific items below.

a. For tests involving audit sampling, the auditor should document the applicable elements discussed in FAM 495 D, including
   - the sampling method used;
   - the sample size and the method of determining it;
   - the data reliability tests performed to verify that the population from which the sample will be selected is complete and valid;
   - how the sample was selected;
   - a list of items tested; and
   - the results of tests, including evaluations of sample results, and conclusions.

   GAO auditors generally should use FAM 495 D and provide it to the auditing sampling specialist for review.

b. For substantive analytical procedures, the auditor should document the following:
   - the model used to develop the expectation and the basis for the model, including the expectation referred to in FAM 475.04 and the factors considered in its development when that expectation or those factors are not otherwise readily determinable from the audit documentation (AU-C 520.08a);
   - the data used and the data sources;
   - the auditor's assessment of the reliability of the data used and procedures performed to establish or increase the amount of reliability, if applicable;
   - the amount of the limit and the criteria for establishing the limit;
   - results of the comparison referred to in FAM 475.04 of the recorded amounts, or ratios developed from recorded amounts, with the expectations (AU-C 520.08b), including management's explanations for

significant fluctuations, sources of these explanations, and corroborating evidence obtained;

- any additional auditing procedures performed relating to the investigation of fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount and the results of such additional procedures (AU-C 520.08c); and
- conclusions regarding findings, including treatment of any misstatements detected and assessment of any other effects of these misstatements.

c. The auditor should document interim testing procedures (see FAM 495 C for documentation guidance).

d. The auditor should document individual and total misstatements on the summary of uncorrected misstatements. See FAM 540 and FAM 595 C.

e. For audit procedures related to the inspection of significant contracts and grant agreements, the auditor should include abstracts or copies of those contracts and grant agreements in the audit documentation (AU-C 230.10).

Determining whether an inspected contract or grant agreement is significant is a matter of auditor judgment. In making this determination, the auditor may find it necessary to consult with OGC to gain a better understanding of the contract or grant agreement.

If a contract or grant agreement is deemed to be significant, the auditor should include information about the contract or grant agreement in the audit documentation. At a minimum, the audit documentation should include abstracts or copies of significant contracts and grant agreements examined if they are needed to allow an experienced auditor to understand the work performed and conclusions reached. The following considerations may help guide the auditor in determining whether a contract or grant agreement is significant and whether to obtain and maintain an abstract or copy in the audit documentation:

- Risk – Matters arising from contracts or grant agreements that an auditor considers to be a significant risk. Factors in making that determination include complexity, uniqueness, congressional or public interest, and whether it is outside the normal course of business.
- Materiality – Individual or classes of contracts or grant agreements that are individually or collectively material, considering both quantitative and qualitative materiality. If there is a class of similar contracts or grant agreements, the auditor may determine that only examples of such contracts or grant agreements or abstracts summarizing the class are necessary to include in the audit documentation. Factors in making this determination include transactions and balances recorded under a contract or grant agreement that are material to the financial statements, and contracts or grant agreements that are significant or fundamental to the operations of the entity.
- Disclosure – Matters or transactions arising from contracts or grant agreements that could be disclosed in the financial statements, notes, required supplementary information, and other information.

- Internal control over financial reporting – Internal controls over financial reporting that the auditor has determined are relevant to the audit, especially those performed by service organizations.
- Auditor's report – Issues or transactions arising from contracts and grant agreements that the auditor has determined to be significant and included in the auditor's report as emphasis-of-matters or other-matters.

f. For accounting estimates, the auditor should document the following (AU-C 540.38):

- the auditor's responses when management has not taken appropriate steps to understand and address estimation uncertainty;
- indicators of possible management bias, if any, and the auditor's evaluation of the implications for the audit;
- significant judgments relating to the auditor's determination of whether the accounting estimates and related note disclosures are reasonable in the context of the applicable financial reporting framework (generally U.S. GAAP) or are misstated.

In documenting the linkage of the auditor's further audit procedures with the risks of material misstatement at the assertion level for accounting estimates in accordance with FAM 490.01, the auditor should take into account the reasons given to the assessment of those risks. Those reasons may relate to one or more inherent risk factors or the auditor's assessment of control risk. However, the auditor is not required to document how every inherent risk factor was taken into account in identifying and assessing the risk of material misstatement in relation to each accounting estimate. (AU-C 540.38 and .A149)

495 A – Determine Whether to Perform Substantive Analytical Procedures

.01 When determining whether performing substantive analytical procedures will be effective and efficient as a substantive test, the auditor should evaluate the

a. nature of the account balance, the audit objective (including the assertions being tested), and the assessed level of risk of material misstatement (FAM 495 A.02–.04);

b. expected availability and reliability of explanations for fluctuations and related corroborating evidence (FAM 495 A.05);

c. plausibility and predictability of the relationship (FAM 495 A.06–.13);

d. availability and reliability of data (FAM 495 A.14–.22); and

e. preciseness of the expectation (FAM 495 A.23–.25).

This FAM section provides additional guidance to the auditor in these areas.

Nature of the Account Balance, the Audit Objective, and the Assessed Level of Risk of Material Misstatement

.02 Analytical procedures are usually more effective for testing accounts that accumulate transactions for the period, such as statement of net cost accounts, than for testing balance sheet accounts. This is because balance sheet amounts are more difficult to predict as they are as of a specific point in time. Additionally, net cost statement amounts generally have relationships with other data, such as cost of sales as a percentage of sales, interest expense as a function of the debt balance and interest rates, or sales revenue as a function of the number of units shipped and the average sales price. Analytical procedures are usually less effective for testing amounts that are subject to management discretion or are unpredictable, such as repairs or miscellaneous expenses.

.03 The auditor should consider the audit objective, including the assertions being tested, and the assessed level of risk of material misstatement in determining whether substantive analytical procedures will be effective. The auditor can obtain three levels of substantive assurance from analytical procedures—complete, partial, or none. The effectiveness and the amount of assurance that an individual procedure provides are matters of the auditor's professional judgment and are difficult to measure.

.04 When the risk of material misstatement is high, the auditor will rarely be able to place complete reliance on analytical procedures for substantive assurance, particularly for balance sheet accounts. Therefore, in these cases, the auditor should design analytical procedures that are extremely effective and persuasive, if they are to serve as the sole source of audit evidence for achieving the audit objective. For significant risks, when the audit approach consists only of substantive tests (i.e., because controls are not effective), the auditor should not place complete reliance on substantive analytical procedures (see FAM 470.03).

Explanations for Fluctuations and Corroborating Evidence

.05 Explanations for fluctuations and related, reliable corroborating evidence may not be readily available. This evidence is essential when the auditor uses analytical procedures as a substantive test. The auditor could consider the relative ease of obtaining explanations for significant differences and relevant, reliable corroborating evidence when determining whether analytical procedures will be effective.

Plausibility and Predictability of the Relationship

.06 Relationships between the amount being tested (the recorded amount) and the other data are an essential component of substantive analytical procedures. The auditor should identify relationships that are good indicators of the account balance, that is, the relationship between the recorded amount and the other data is plausible and predictable.

Plausibility

.07 If one set of data provides a reasonable basis for predicting another set of data, the relationship between the two sets of data is plausible. As the plausibility of the relationship increases, so does the effectiveness of analytical procedures as a substantive test.

.08 For example, there is a plausible relationship between payroll expense, the average number of employees, and the average pay rate. This relationship generally is effective for the auditor to use in developing an expectation for payroll expense of salaried employees. Alternatively, there is not usually a plausible relationship between revenue and interest expense. Therefore, this relationship would not be used for developing an expectation.

Predictability

.09 The more predictable the relationship is, the more effective the substantive analytical procedure will be. Relationships are more predictable in a stable environment. As relationships become more complex because of increases in the number and type of contributing factors, related amounts become more difficult to effectively and efficiently predict.

.10 For example, payroll expense generally is very predictable if there is little employee turnover during the period, if all employees receive the same percentage raise at the same time, and if all employees are salaried. Payroll expense becomes more difficult to predict if any of these factors changes, such as high turnover resulting in a different mix of employee pay, a wide range of raises awarded at different times, or a mix of hourly and salaried employees. Therefore, to effectively estimate payroll expense, the auditor may need to use a more complex relationship that considers these factors.

.11 The relationships may be between the recorded amount and either prior-year or current-year data, using financial or nonfinancial data, including underlying business factors. For example, the auditor may determine an expectation for (1) current-year interest expense using current-year **audited**, long-term debt amounts and interest rate information or (2) estimating budgetary gross outlays based on known relationships with related audited proprietary accounts, such as operating expenses, payables, and capital acquisitions, and comparing this

amount to the balance reported on the statement of budgetary resources. When using current-year relationships, the auditor should test the data used to develop the expectation by a method other than a substantive analytical procedure that uses a relationship with the recorded amount.

.12 The auditor should develop a rationale for using prior-year amounts as the only basis for the expectation. The auditor should document why, in the auditor's professional judgment, the prior-year amount—and any adjustments to that amount—has a plausible and predictable relationship with the current-year recorded amount. The auditor could consider testing any adjustments to the prior amount, such as for the effects of inflation. Additionally, the auditor should determine whether the prior-year amount is reliable. The easiest way to determine this is if the prior-year amount is audited.

.13 For an example of prior-year relationship, assume that the payroll raises for the current year were authorized at 5 percent and that the number and salary mix of employees have remained relatively stable. In this example, the auditor may reasonably expect current-year payroll expense to be 5 percent higher than the prior year's payroll expense. However, the auditor would need to test the reliability of the percentage pay increase and the assumptions regarding the number and mix of employees.

Data Considerations

Availability of Data

.14 Data needed to perform analytical procedures may not be readily available. The auditor generally should determine when data will be available and the relative ease of obtaining relevant, reliable data when determining whether analytical procedures will be efficient and effective.

Reliability of Data

.15 The more reliable data are, the more effective analytical procedures will be as a substantive test. In assessing the reliability of data, which is a matter of the auditor's professional judgment, the auditor should evaluate

- the source of the data, including whether the data are audited or unaudited;
- conditions under which the data were developed and gathered, including related internal controls; and
- other knowledge the auditor may have about the data.

Sources of Data

.16 Data obtained from an independent source outside the entity are generally more reliable than data obtained from inside the entity. However, the auditor should determine if the outside information is comparable to the item being tested. This issue of comparability is important if the auditor is using industry statistics.

.17 Data obtained from entity sources are more reliable if the sources are independent of the accounting function and if the data are not subject to manipulation by personnel in the accounting function. If multiple data sources are used, the auditor should determine the reliability of all sources used.

Audited versus Unaudited Data

.18 The auditor should determine whether the data are audited or unaudited because audited data are more reliable than unaudited data. (See FAM 600 on using the work of others.)

.19 Unaudited data are not reliable unless the auditor performs procedures to establish their reliability. These procedures could consist of either evaluation and tests of controls over data production or tests of the data. The extent of such procedures is a matter of professional judgment and should be documented. For example, interest rates from an entity's loan register may be used to estimate interest income. The reliability of this information may be established by including the interest rate on loan confirmations that are sent to the borrowers or by reviewing original loan documents.

Conditions under Which the Data Were Gathered

.20 Another consideration for internal data is whether the data were developed under a reliable system with adequate financial reporting or operations controls. The auditor may test operations controls to assess the reliability of the data used for substantive analytical procedures. The extent of this testing is a matter of the auditor's professional judgment.

.21 If the system used to develop internal data is computerized rather than manual, the auditor should perform additional procedures before relying on the data. The auditor should test either (1) the general controls and the specific application controls over the information system that generated the report or (2) the data in the report.

.22 An auditor may test operations controls when using entity-prepared statistics for a substantive analytical procedure. For example, the auditor may use Air Force statistics to test the reasonableness of its Airlift Services' aircraft operating costs. The auditor may compare the per hour fuel and maintenance costs for Airlift Services' cargo and passenger aircraft with the "block hour" costs that major airlines incur for similar aircraft, as published in *Aviation Week* and *Space Technology*. The auditor would first determine if the industry statistics are comparable, for example, if the statistics are for the same or similar types of aircraft and if the types of items included in maintenance costs are similar. The auditor may then identify and test the internal controls over the production of these operating statistics.

Preciseness of the Expectation

.23 The auditor should develop an expectation of the account balance that is precise enough to provide the desired substantive assurance. When determining how precise the expectation should be, the auditor should determine the proper balance between effectiveness and efficiency. Any work to make the expectation more precise than the desired level of assurance is unnecessary.

.24 If the audit objective cannot be achieved with the original expectation, the auditor may be able to perform additional procedures to make the expectation more precise. The preciseness of the expectation and changes in this preciseness are difficult to measure in quantifiable terms, unless the auditor uses regression analysis in performing the analytical procedures. The auditor generally should consult with the audit sampling specialist before using regression analysis.

.25 Factors that influence the expectation's preciseness follow:

- **The identification and use of key factors when building the model based on the relationships the auditor identifies.** The expectation generally becomes more precise as additional key factors are identified.
- **The reliability of the data used to develop the expectation.** The expectation becomes more precise as the reliability of the data increases.
- **The degree of disaggregation of the data.** The expectation becomes more precise as the disaggregation of the data increases.

495 B – Example Procedures for Tests of Budget Information

.01 This section includes examples of procedures that auditors may perform in testing budget information for the statement of budgetary resources and reconciliation of net cost to net outlays.[20]

.02 In addition, if budget controls are ineffective and quantitative provisions of budget-related laws and regulations are significant, the auditor generally should perform audit procedures sufficient to detect material misstatements in the types of budget information listed in FAM 460.04. Tolerable misstatement for use in determining sample sizes is discussed in FAM 460.03.

Testing Obligations and Expended Authority Transactions

.03 The following are examples of procedures that the auditor may use to test obligation[21] and expended authority transactions for these misstatements.

Validity, accuracy/valuation, and classification assertions:

a. Select obligations recorded as of the end of the audit period and expended authority transactions recorded during the audit period.

b. Determine if each selected item is a valid obligation or expended authority transaction based on the criteria set forth in FAM 395 F.

c. Determine if each selected item is recorded at the accurate amount (value).

d. Determine if each selected item is properly classified in the appropriation or fund account (also by program and by object, if applicable), including the proper appropriation year.

e. Test upward and downward adjustments of obligations. Determine whether selected adjustments are supported by formal decisions and any necessary documentation that has been fully executed (e.g., SF-30 for contract amendments). If any of these adjustments relate to closed accounts, determine whether the adjustments comply with the requirements for closing appropriation accounts under 31 U.S.C. §§ 1551-1558. See FAM 395 E for guidance on the budget execution process.

Completeness and cutoff assertions:

[20]Per OMB reporting guidance, the reconciliation of net cost to net outlays may be presented as a financial statement or note to the financial statements.

[21]An obligation, as defined in OMB Circular No. A-11, is a binding agreement that will result in outlays, immediately or in the future. GAO's Federal Budget Glossary (GAO-05-734SP) defines obligation as a definite commitment that creates a legal liability of the government for the payment of goods and services ordered or received, or a legal duty on the part of the United States that could mature into a legal liability by virtue of actions on the part of the other party beyond the control of the United States. Payment may be made immediately or in the future. An agency incurs an obligation, for example, when it places an order, signs a contract, awards a grant, purchases a service, or takes other actions that require the government to make payments to the public or from one government account to another. As a general rule, absent a specific statutory authority, the amount of the obligation is the maximum liability to the federal government. An entity's budgetary obligation is not the same as its accounting liability, which is a probable future outflow or other sacrifice of resources as a result of past transactions or events (e.g., receipt of goods or services). The entity's budgetary obligation is reported on the statement of budgetary resources whereas its accounting liability is reported on the balance sheet.

f. Select obligations and expended authority transactions recorded during the period between the balance sheet date and a date near the auditor's report date.

g. Examine open purchase orders, unpaid invoices, and contracts as of a date near the auditor's report date.

h. Select items representing payments by the Department of the Treasury or cash disbursements by the entity during the audit period. Substantive detail test selections of expenses and additions to inventory, property, and prepaid accounts may be used for this purpose if the populations from which they are selected are complete.

i. For each selection, determine whether the obligation or expended authority transaction is recorded in the proper period. If transactions are not recorded, or are recorded in the incorrect period, determine the effects of this misstatement on budget amounts, the evaluation of budget controls, and the risk of material misstatement.

j. If the selected obligation or expended authority transaction relates to the audit period and is recorded in that period, determine if it is recorded at the proper amount and properly classified in the appropriation or fund account (also by program and by object, if applicable), including the proper appropriation year.

Summarization assertion:

k. Test the footing of the detail of the obligation account balance recorded as of the end of the audit period and expended authority accounts recorded during the audit period.

l. Reconcile the total of these details to the recorded totals for obligation and expended authority accounts as of the end of the audit period. Audit software is often an effective tool for footing the transactions recorded in the accounts and for selecting items for testing.

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

Testing Outlay Transactions

.05 The following are examples of procedures that the auditor may use to test outlay transactions. The auditor generally should coordinate these audit procedures with the audit of the other financial statement amounts, chiefly cash disbursements.

Validity and classification assertions:

a. Select outlays recorded during the audit period. Determine if an invoice and a receiving report support each selected outlay. Determine the obligation that was liquidated by the outlay.

b. Examine the support for the obligation and determine if the invoice billed for goods or services is related to or properly "matches" the obligation and, in turn, the appropriation.

c. Obtain the accounting data for the matched obligation, including appropriation and year. Match these data to the type of services paid for by the selected outlay. Determine if the related appropriation authorizes payment for the services billed and paid.

495 C – Guidance for Interim Testing

Misstatements in Interim Balances

.01 If the auditor detects unexpected misstatements when assessing the risks of material misstatement at an interim date, the auditor should evaluate whether the related assessment of risk and the planned nature, timing, or extent of substantive procedures covering the remaining period need to be modified (AU-C 330.24). See FAM 295 D for a discussion of factors in deciding whether to use interim substantive testing. The auditor should determine the effects of misstatements by evaluating relevant factors, including

a. the nature and cause of the misstatement;

b. the estimated effects on the overall line item, account, note disclosure, or class of transactions;

c. whether the entity has subsequently corrected the misstatement; and

d. the impact of the misstatement on other parts of the audit.

.02 The auditor should discuss misstatements with management. Based on the nature and cause of the misstatements detected, the auditor should determine, and obtain supporting evidence on, whether misstatements are likely to occur in the remainder of the line item, account, note disclosure, or class of transactions at the interim testing date and at year-end. See FAM 480.35 for a discussion of the need to project all misstatements unless evidence is highly persuasive that a misstatement is isolated and the audit director approves.[22]

The auditor should request that entity management correct such misstatements in the population. Based on the following guidance, the auditor should use professional judgment to determine the extent to which interim testing can be relied on, in conjunction with substantive procedures in the roll-forward period, to provide sufficient appropriate evidence on the year-end balance or activity:

a. If the misstatements are not material when projected to the entire population (projected misstatements plus an allowance for further misstatements is less than tolerable misstatement) and are expected to be representative of the misstatements at year-end, the auditor may rely upon the results of the interim testing.

b. If the auditor has obtained highly persuasive evidence that the misstatements are isolated (generally by nature, cause, or extent), the auditor may be able to rely on unaffected parts of the interim testing and apply procedures at year-end to test only those assertions associated with the misstatements.

   For example, in interim testing of inventory, the auditor might determine that the misstatements concern only the valuation of inventory. Accordingly, the auditor may rely on other parts of the interim testing, such as those for the

[22]The auditor cannot assume that an instance of fraud or error is an isolated occurrence. Therefore, the consideration of how the detection of a misstatement affects the assessment of risks of material misstatement is important in determining whether the assessment remains appropriate (AU-C 330.A78).

accuracy of the physical count and cutoff, and perform detail valuation testing and related procedures at year-end.

c. If the misstatements are material or pervasive, the auditor should determine (1) whether to place any reliance on the interim testing, (2) the effect on the risk of material misstatement, and (3) the nature and extent of substantive procedures to be performed on the line item, account, note disclosure, or class of transactions as of the balance sheet date.

.03 For any misstatements found during interim testing, the auditor uses professional judgment to evaluate, in a manner appropriate for the circumstances, the effects on the year-end balance.

Testing the Roll-Forward Period

.04 Because the auditor reports on the financial statements as of year-end, not the interim test date, the auditor should perform further substantive procedures combined with tests of controls to cover the remaining period.

For example, after interim testing of the loans receivable balance as of June 30, the auditor may examine supporting documents for selected debits and credits to the balance during the roll-forward period of July 1 through September 30. The auditor may also apply analytical procedures to compare the roll-forward period activity, on a month-by-month basis, with expectations based on results for preceding months or similar periods of preceding years.

.05 The auditor should determine the nature and extent of substantive procedures based on the assessment of risk of material misstatement. In some instances, the auditor may determine that a specific risk of material misstatement warrants additional or different substantive procedures at year-end, such as cutoff tests. If the risk of material misstatement is moderate or low, the auditor generally should determine whether the internal controls as of the interim testing date were in place and were operating effectively during the roll-forward period.

.06 When the auditor reports on the effectiveness of controls as of a specific date and obtains evidence about the operating effectiveness of controls at an interim date, the auditor should determine what additional evidence concerning the operation of the controls for the remaining period is necessary (AU-C 940.40). The additional evidence necessary to update the results of testing from an interim date to the entity's period-end depends on the following factors:

a. the specific control tested prior to the as-of date, including the risks associated with the control, the nature of the control, and the results of those tests;

b. the sufficiency of the evidence of operating effectiveness obtained at an interim date;

c. the length of the remaining period; and

d. the possibility that there have been any significant changes in internal control subsequent to the interim date.

.07 The auditor's tests of controls for the roll-forward period should consist of procedures in addition to inquiry. For example, if management asserted that controls at year-end did not change since the interim period, the auditor should obtain evidence supporting management's assertion. This may include inspecting

selected documentation or observing selected controls being performed that provides sufficient evidence that controls were in place and operating effectively during the roll-forward period. The auditor's determination of which controls to review and how much evidence to obtain for the roll-forward period is a matter of professional judgment.

Documentation

.08 The auditor should document

a. line items, accounts, note disclosures, classes of transactions, and assertions to which interim testing is applied;

b. the basis for using interim testing;

c. audit procedures used to test interim balances or activity and the roll-forward period (including tests of controls, findings, and conclusions);

d. effects of any misstatements found during interim testing and roll-forward testing; and

e. conclusions on the line items, accounts, note disclosures, or classes of transactions as of and for the year.

495 D – Selection Methods

Selection Methods Flowcharts and Example Audit Documentation

.01 This section contains selection methods flowcharts and example audit documentation.

.02 Flowchart 1 (FAM 495 D-2) assists the auditor in determining the selection method for substantive tests. Selection methods are either (1) statistical sampling (representative of, and statistically projectable to, the population), (2) nonstatistical sampling (representative of, but not statistically projectable to, the population), or (3) nonstatistical selection (not representative of, and not statistically projectable to, the population). If the auditor decides to use statistical sampling or nonstatistical sampling, the auditor generally should consult with the audit sampling specialist, including for selection of sampling methods, selection of sample items, and evaluation of sampling results.

.03 Flowchart 2 (FAM 495 D-3) helps the auditor determine the type of statistical sampling to use. The choices are (1) attribute sampling, (2) MUS, and (3) classical variables sampling.

When testing for overstatement in the defined population and expecting a large misstatement rate, the auditor may use classical PPS sampling. See FAM 480.29 through .30 and FAM 480.39 for further information.

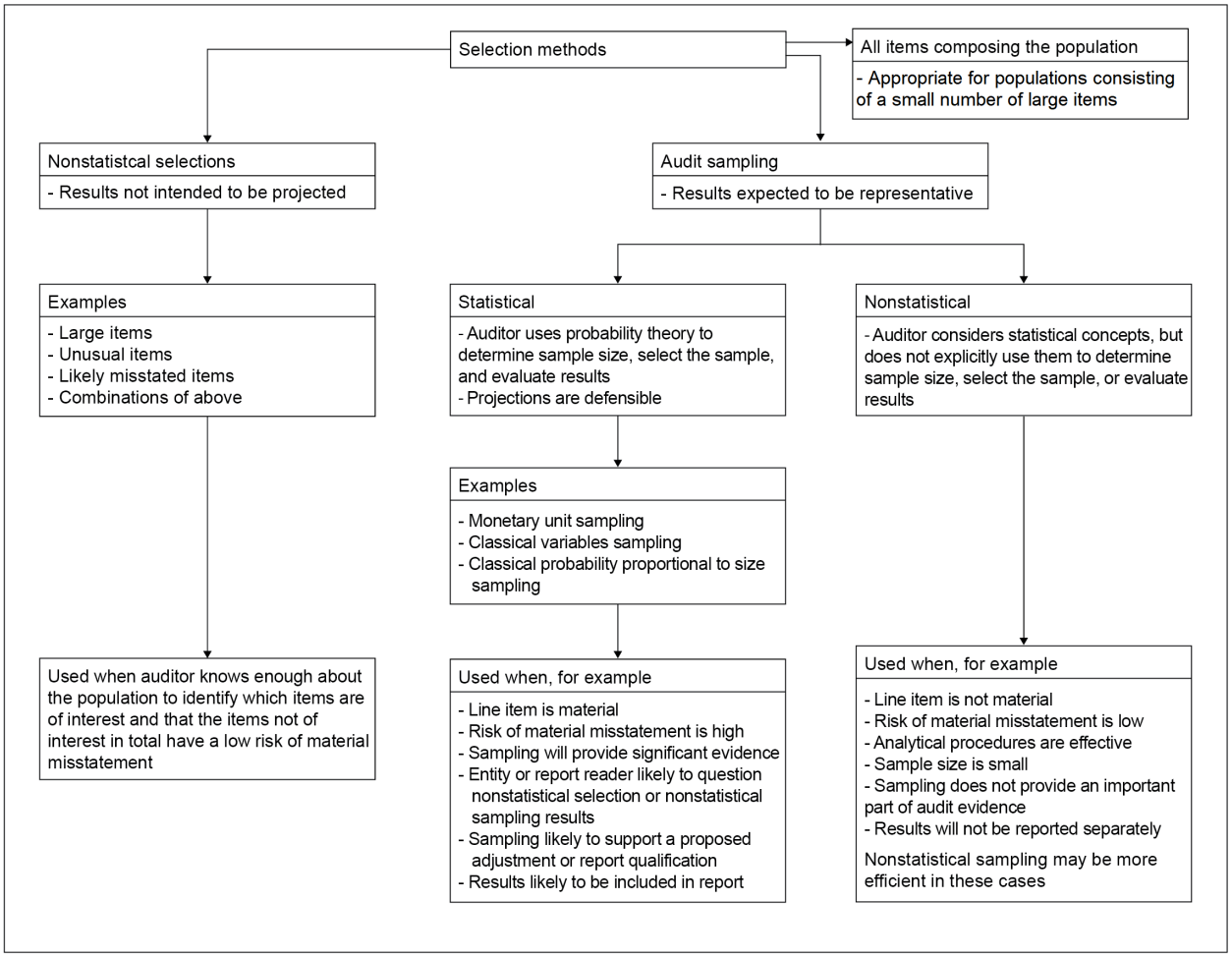
.04 The remaining flowcharts are to assist the auditor in performing

- attribute sampling at FAM 495 D-4 (flowchart 3),
- MUS at FAM 495 D-5 (flowchart 4), and
- classical variables sampling at FAM 495 D-6 (flowchart 5).

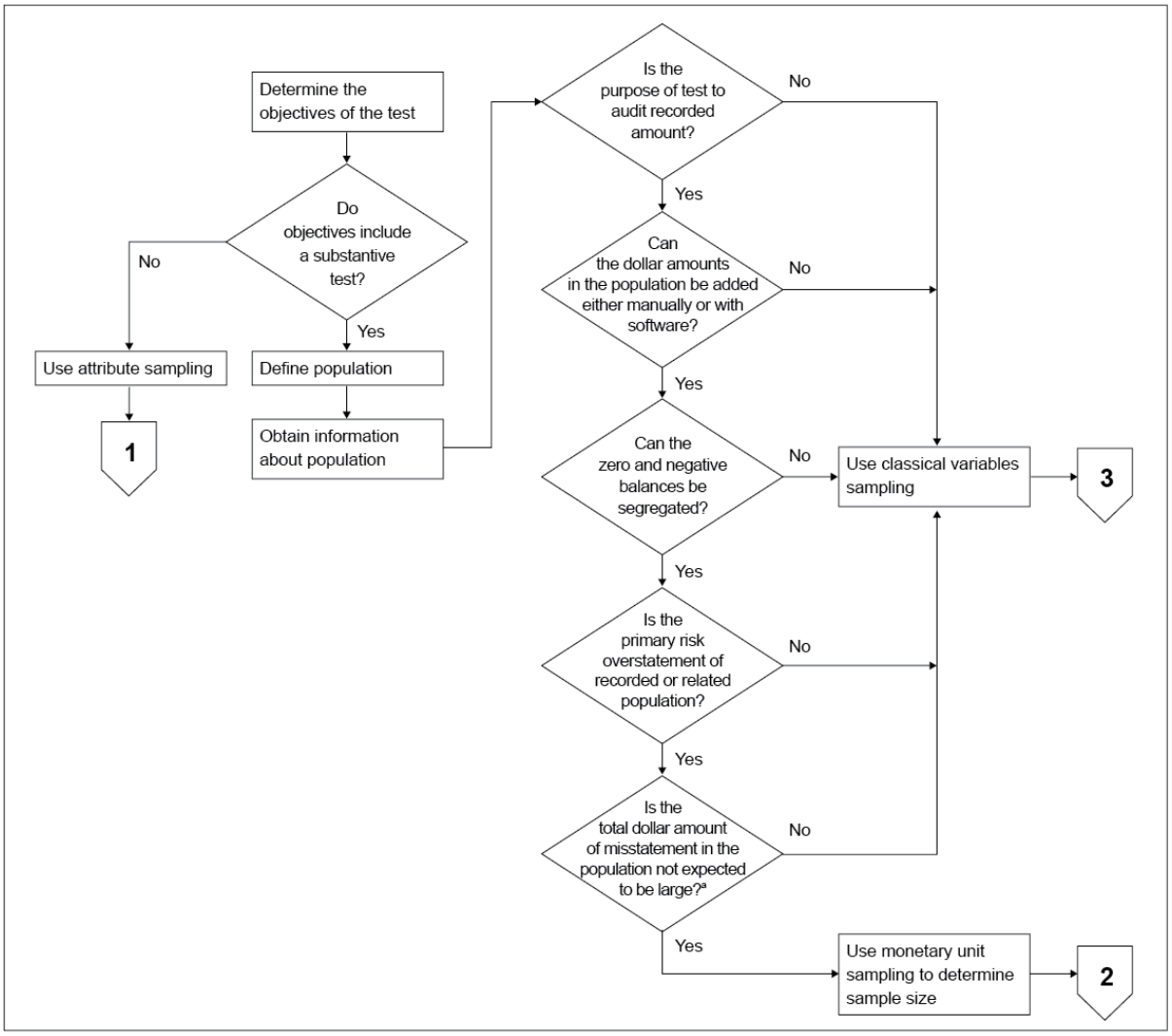
.05 Examples of audit documentation for sampling are provided for

- attribute sampling at FAM 495 D-7 through D-10,
- MUS at FAM 495 D-11 through D-15, and
- classical variables sampling at FAM 495 D-16 through D-19.

Flowchart 1: Determining the Selection Method for Substantive Tests

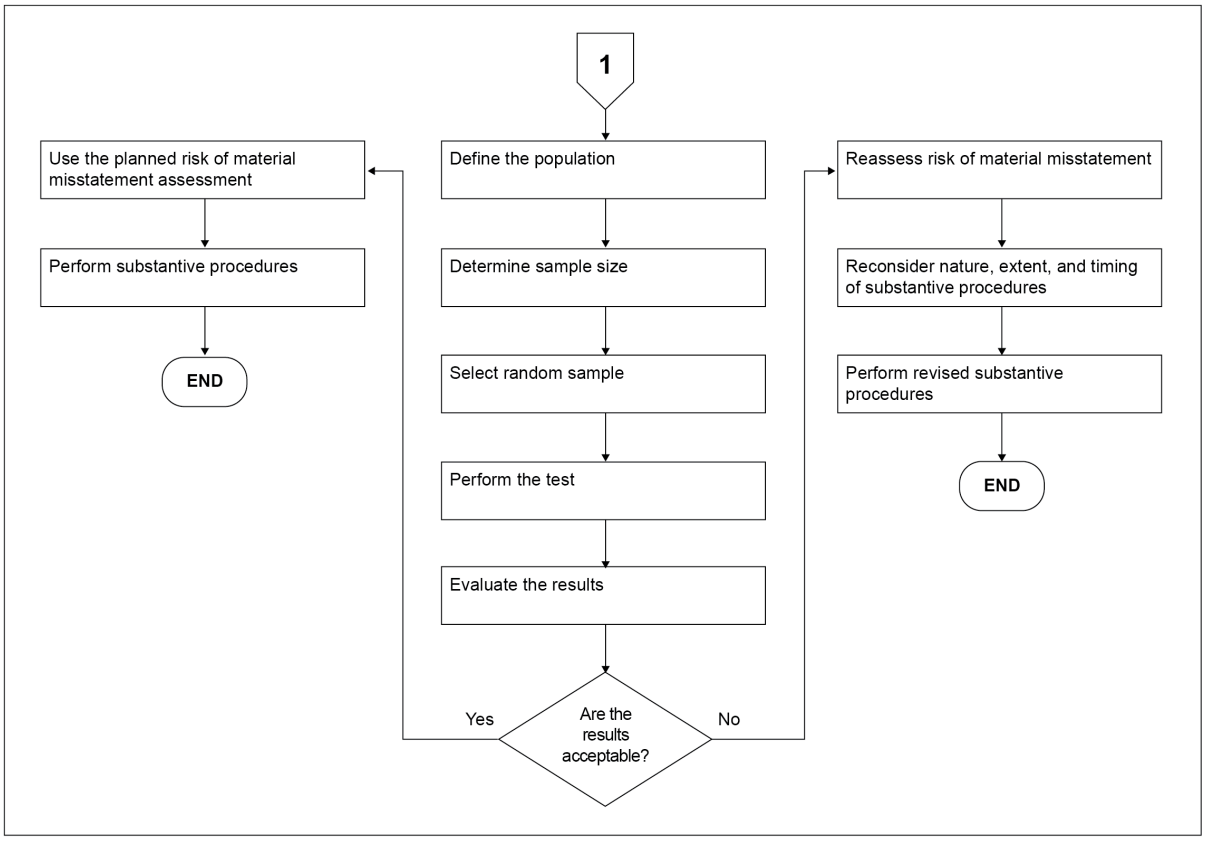


Flowchart 2: Determining Which Type of Statistical Sampling to Use

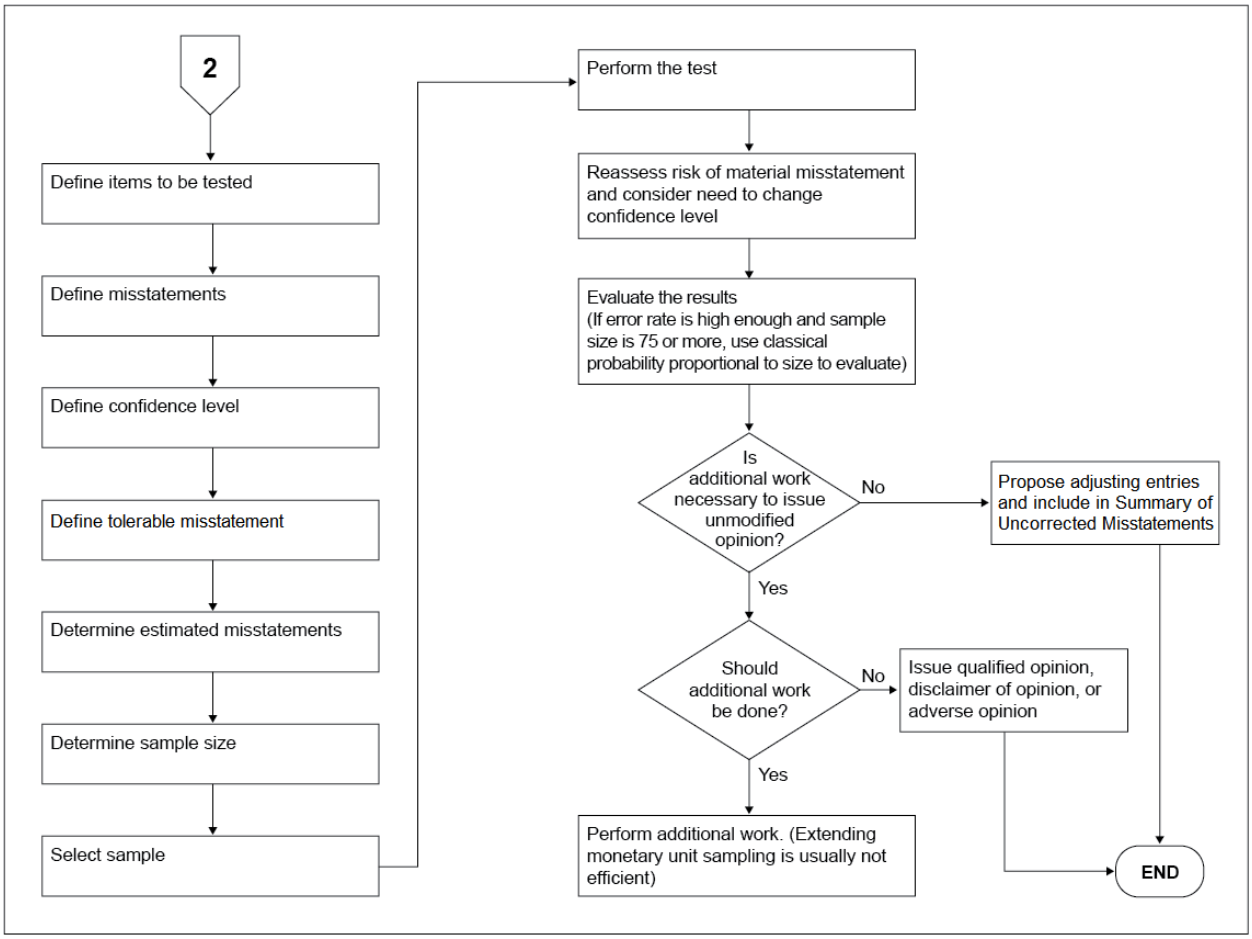


[a]For GAO, large means more than 30 percent of sampling units are expected to contain misstatements. When GAO auditors expect that 10 percent or fewer of the sampling units contain misstatements, GAO auditors use monetary unit sampling. When GAO auditors expect that 10 to 30 percent of the sampling units contain misstatements, they consult with the audit sampling specialist.

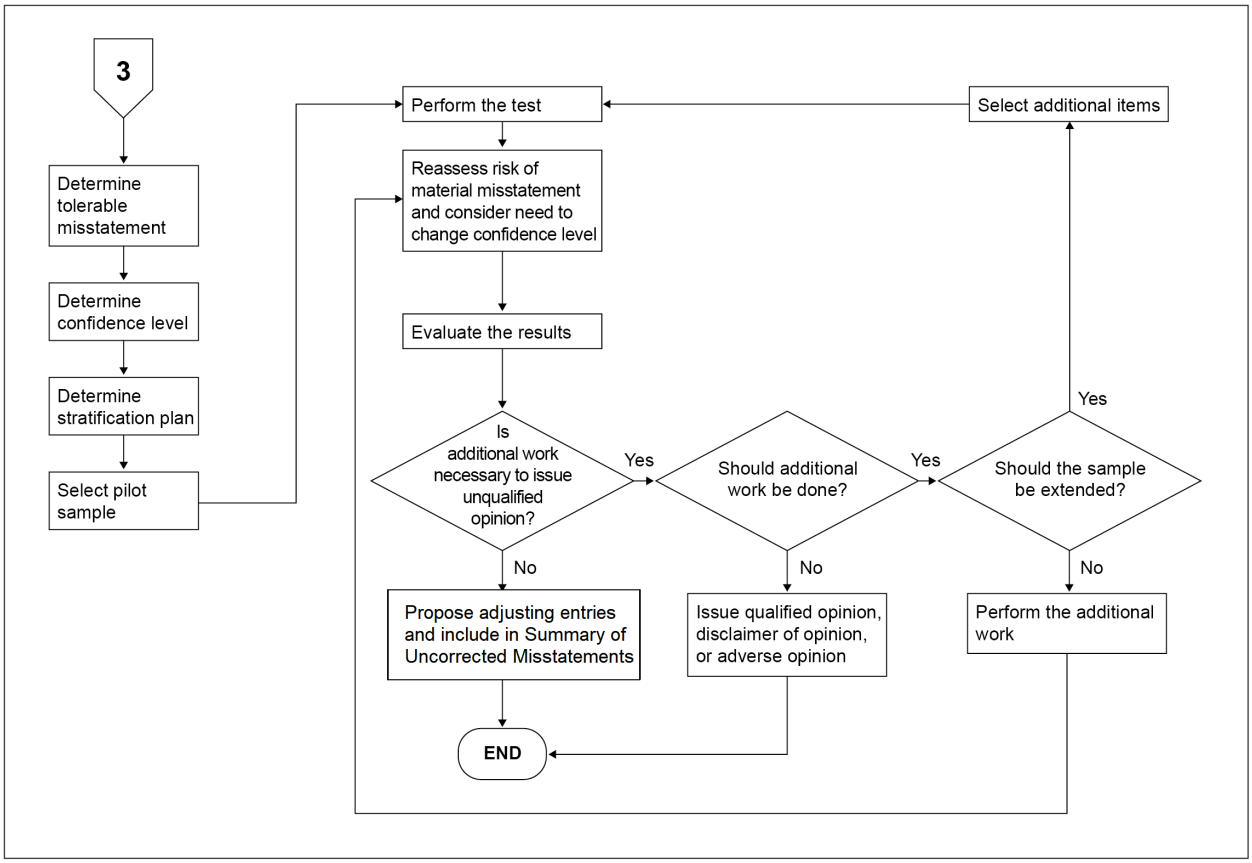
Flowchart 3: Testing Using Attribute Sampling



Flowchart 4: Testing Using Monetary Unit Sampling



Flowchart 5: Testing Using Classical Variables Sampling



Example Audit Documentation for Attribute Sampling

Entity: _____

Period ended: _____

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

SECTION I Definition of Control Techniques and Sampling Method for Attribute Sampling

Cycle: _____

Application: _____

Control activities (from SCE worksheets): _____

_____

Sampling method: [ ] Random using IDEA/other audit software

Documentation reference to IDEA/other audit software output: _____

[ ] Other – explain: _____

_____

SECTION II Definition of Population and Attributes to Test for Attribute Sampling

Population is: _____

Population size: _____ units

Attributes to test: _____

_____

Document(s) to examine: _____

_____

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

_____

_____

_____

Data reliability tests performed to verify that the population from which the sample will be selected is complete and valid (see FAM 450.05): _____

_____

_____

SECTION III Determination of Sample Size and Evaluation of Sample Results for Attribute Sampling

Control activity number	Deviation definitions (each will constitute a deviation)[a]	Preliminary assessment of control risk (see SCE worksheet)	Sample size (per FAM Figure 450.1, IDEA, or other source)	Acceptable number of deviations	Number of deviations found	Is result acceptable?[b,c]
		A	B	C	D	E

[a]Insert deviation definitions and data for columns A through C for each control technique before selection of sample.

[b]Results are acceptable if column D is less than column C. When results are unacceptable, complete section IV.

[c]If the attribute sample was selected through MUS as part of multipurpose testing and all items in the MUS sample are tested for attributes, then auditors should use IDEA's MUS evaluation module instead of FAM Figure 450.1 to evaluate the results.

Method of testing for more than one control activity:

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

SECTION IV Control Deviations Identified in Attribute Sampling

Deviation	Possible cause	Line items, accounts, note disclosures, classes of transactions, and assertions affected	Further action taken	Control risk assessment (low, moderate, high)*

SECTION V Basis or Explanation for Control Risk Assessment

*Where the preliminary assessment of control risk is low, the risk may be assessed as moderate if the number of deviations found does not exceed the acceptable number of deviations in table II of FAM Figure 450.1 for the same sample size.

Example Audit Documentation for MUS

Entity:				
Period ended:				
	During Planning		At End of Test	
	Initials	Date	Initials	Date
Prepared by:				
Reviewed by:				

SECTION I Define Objectives and Method of Testing for MUS

Line Item, Account, or Class of Transactions:

Assertion:

Test:

SECTION II Define Population for MUS

Population is: _____

Population size: _____ monetary units (dollars)

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

Direction of test: Starting from (source): _____

Testing to (documents to be examined): _____

When this period is less than the entire period under audit or where the population being tested is less than the population in the financial statements, describe briefly (and cross-reference to) procedures performed to determine that the remainder of the population does not contain a risk of material misstatement: _____

Data reliability tests performed to verify that the population from which the sample will be selected is complete and valid (see FAM 480.01): _____

Population analyzed (see FAM 480.01) by:

[ ] Review of printout of population
[ ] Review of manual listing of population
[ ] IDEA/other audit software stratification
[ ] Other computer-assisted method – describe: _____

SECTION III Determine Sample Size and Interval for MUS

a. Total population (from Section II): _____

b. Risk of material misstatement from the LIRA form: _____

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

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

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

f. Minimum substantive audit assurance from detail tests: _____

g. For MUS using IDEA/other audit software: 1. Confidence level: _____%

2. Tolerable error (tolerable misstatement): $ _____

3. Expected error (expected misstatement): $ _____

h. Interval based on these factors is: $ _____

Random start or seed is: _____

i. Sample size based on these factors is: _____

Audit documentation reference to: [ ] Software output (IDEA/other audit software) _____

[ ] Manual computation _____

SECTION IV Evaluation of Substantive Tests for MUS

(If many errors are found and the sample size is 75 or greater, the auditor generally should consult with the audit sampling specialist to evaluate and document as classical PPS.)

Known Substantive Misstatements

Misstatement number	(A) Book amount	(B) Audited amount	(C) Misstatement amount (A–B)	Nature of misstatement	Possible cause	
Items greater than sampling interval						
1						
2						
3						
Total*						
				(D) Misstatement as a percentage of book amount* (C/A)		Should misstatement be projected? If not, explain:
Items less than sampling interval						
1						
2						
3						
Total*						

*Calculated amounts may be omitted if calculation was made using IDEA.

Note 1: When sampling from a different population for understatement of a primary population (such as when sampling subsequent disbursements to test completeness of recorded accounts payable), in computing "misstatement as a percentage of book amount" the "book amount" is the subsequent disbursement (not the recorded payable). The audited amount is the amount that was either correctly accrued or not correctly accrued. For example, assume the auditor finds a $10,000 subsequent disbursement that was omitted improperly from accounts payable as of the balance sheet date. The "book amount" is $10,000 and the "audited amount" is zero, thus the "misstatement as a percentage of book amount" is 100 percent. The "book amount" is based on the source of selection, not necessarily what is recorded in the financial statements.

Note 2: If IDEA/other audit software selects an item twice and it is misstated, include the item twice in this listing.

Calculate projected misstatements

(Omit steps E through H if calculated by IDEA)

(E) Number of equivalent complete misstatements in sample from column D on previous page (excluding misstatements found in 100% of examined items – see Note 1 on previous page: _____

(F) Sampling interval _____

(G) Projected misstatements (E x F) _____

(H) Misstatements found in 100% of examined items _____

(I) Total projected misstatement (G + H) (or from IDEA output) _____

(If from IDEA, document reference to IDEA output) _____

Conclusion Are we satisfied that book amount is free from material misstatement? [ ] Yes [ ] No [ ] Not enough evidence

If No or Not enough evidence, what will we do? Explain below:

_____

_____

Example Audit Documentation for Classical Variables Sampling

Entity: _____

Period ended: _____

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

SECTION I Definition Objectives and Method of Testing for Classical Variables Sampling

Line Item, Account, or Class of Transactions: _____

Assertion: _____

Test: _____

Description of 100$ examined items: _____

_____

SECTION II Define Population for Classical Variables Sampling

Population is: _____

Population size: _____ Dollars

_____ Number of items

Direction of test: Starting from (source): _____

Testing to (documents to be examined): _____

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

Data reliability tests performed to verify that the population from which the sample will be selected is complete and valid (see FAM 480.01): _____

Population analyzed by:
[ ] Review of printout of population
[ ] Review of manual listing of population
[ ] IDEA/other audit software stratification
[ ] Other computer-assisted method – describe: _____

SECTION III Determine Sample Size for Classical Variables Sampling

a. Confidence level _____ %

b. Tolerable misstatement $ _____

c. Precision for total population $ _____

d. Strata definitions:

	Stratum	From	To	Number of Items	Dollars
1					
2					
3					
4					
5					
6					
7					
8					
9					
10					

e. Sample size based on these factors is: _____

Audit documentation reference to:

[ ] IDEA/other audit software _____

[ ] Other calculation _____

[ ] Pilot sample estimate _____

SECTION IV Evaluation of Substantive Tests for Classical Variables Sampling

a. Evaluation method – audit documentation reference to:

[ ] IDEA/other audit software _____

[ ] Other calculation _____

[ ] Spreadsheet _____

b. Estimating technique

[ ] Direct projection

[ ] Difference estimation

[ ] Separate ratio

[ ] Combined ratio

[ ] Combined regression

[ ] Other _____

c. Projected misstatement $ _____

Confidence interval

From $ _____ to $ _____ at _____ % confidence level

Conclusion

Are we satisfied that book amount is free from material misstatement? [ ] Yes [ ] No [ ] Not enough evidence

If No or Not enough evidence, what will we do? Explain below:

_____

_____

SECTION 500

Reporting Phase

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510 – Overview of the Reporting Phase

.01 Based on the work in the preceding phases, the auditor decides how to report on, as applicable, the entity's

- financial statements, required supplementary information (RSI) (including management's discussion and analysis (MD&A)), and other information included in the annual report;
- internal control over financial reporting;
- financial management systems' substantial compliance with the three FFMIA requirements (for CFO Act agencies); and
- compliance with significant provisions of applicable laws, regulations, contracts, and grant agreements.

The following sections provide guidance for making these determinations and formulating the report type and form. Guidance is also provided on other activities that the auditor should perform during the reporting phase (see Contents).

520 – Perform Overall Analytical Procedures

Purposes of Overall Analytical Procedures

.01 As the audit nears completion, the auditor should design and perform overall analytical procedures, as discussed in AU-C 520. The purposes of these procedures are

- to determine if an adequate understanding of all fluctuations from expectations and relationships in the financial statements has been obtained; or if not, to identify and resolve significant or unusual fluctuations from expectations that have not been identified and resolved in other audit procedures;
- to determine if other audit evidence is consistent with explanations for fluctuations from expectations documented during overall analytical procedures; and
- to assist the auditor when forming an overall conclusion about whether the financial statements are consistent with the auditor's understanding of the entity (AU-C 520.06).

.02 If overall analytical procedures indicate that an adequate understanding of relationships and fluctuations has not been obtained or if there are inconsistencies in audit evidence gathered from other audit procedures, the auditor should make further inquiries and perform sufficient testing to obtain an adequate understanding or to resolve the inconsistencies.

.03 The auditor may perform overall analytical procedures in more detail than the financial statement level (supplemental analytical procedures, as discussed in FAM 475) and then use the results of these procedures to "roll up" into and support the overall analytical procedures at the financial statement level. For example, the auditor may perform overall analytical procedures at the account level and roll them up to the financial statement line item to which they belong.

.04 The auditor may use analytical procedures to obtain complete or partial substantive assurance for certain accounts or to perform supplemental analytical procedures when detail tests are used exclusively to obtain substantive assurance. The auditor may use information obtained during these procedures as the basis for explanations of fluctuations for overall analytical procedures.

.05 Audit efficiency and effectiveness may be gained if the same audit staff that conducted the detail tests on an account also conduct the supplemental analytical procedures by building on the knowledge obtained during detail testing.

.06 The auditor generally should coordinate overall analytical procedures with the evaluation of the MD&A, including forming conclusions about the information in it. See FAM 280.08 for guidance on performing procedures over RSI.

Performance of Overall Analytical Procedures

.07 The auditor should achieve the purposes of overall analytical procedures described above by taking the following actions:

a. **Assessing expectations.** The auditor should determine if expectations previously developed during preliminary analytical procedures in FAM 225 are still appropriate or should be revised.

b. **Comparing current-year amounts with expectations.** This information may be on a summarized level, such as the level of financial statements, or a more detailed level, as discussed in FAM 520.03.

c. **Identifying significant or unusual fluctuations from expectations that have not already been identified and resolved.** The auditor should determine whether previously established parameters for determining whether a fluctuation is significant are still appropriate. Parameters are usually based on performance materiality. Unusual fluctuations include inappropriate accounting balances (such as debit balances in liability accounts), balances with either no current-year or no prior-year comparison, and decreases in property accounts that would normally occur only by disposition (instead of by misstatements) or inconsistencies with other relevant information obtained during the audit (AU-C 520.08c). Fluctuations identified are a matter of the auditor's professional judgment. The auditor should also evaluate the absence of expected fluctuations when identifying significant fluctuations (such as lower foreclosure rates on home loans despite higher default rates).

d. **Understanding identified fluctuations from expectations.** The auditor should understand all significant fluctuations identified, obtain audit evidence corroborating the causes, and document the causes. The documentation may be a brief description with a reference to corroborating audit evidence. If the auditor does not understand the cause of a fluctuation or if the understanding is not consistent with the audit evidence, the auditor should perform procedures to obtain an understanding or to resolve any inconsistencies.

e. **Evaluating the results of overall analytical procedures.** The auditor should evaluate these results to determine if the auditor obtained an adequate understanding of significant fluctuations from expectations and if the financial statements are consistent with the auditor's understanding of the entity. If the auditor identifies a previously unrecognized risk of material misstatement, the auditor should revise the auditor's assessment of the risks of material misstatement and modify the audit procedures accordingly (AU-C 520.A26).

530 – Reassess Materiality and Risks of Material Misstatement

.01 In the planning phase, the auditor determined materiality for the financial statements as a whole based on preliminary information. Based on this materiality, the auditor determined performance materiality and tolerable misstatement, which affected the extent of audit testing. Based on AU-C 450.10, before the end of the audit, prior to evaluating the effect of uncorrected misstatements, the auditor should reassess materiality to confirm whether it remains appropriate in the context of the entity's final financial statements. If the reassessment of materiality results in a lower amount (or amounts), then the auditor should reconsider performance materiality and the appropriateness of the nature, timing, and extent of the further audit procedures in order to obtain sufficient appropriate audit evidence on which to base the audit opinion.

.02 In the planning and internal control phases, the auditor identified and assessed the risks of material misstatement at the financial statement and assertion levels. Before the conclusion of the audit, the auditor should evaluate, based on the audit procedures performed and the audit evidence obtained, whether the assessments of the risks of material misstatement at the financial statement and assertion levels remain appropriate (AU-C 315.41 and 330.27). If necessary, the auditor should revise the identification or assessment of these risks. The auditor should determine whether the overall audit strategy and audit plan need to be revised

- if the aggregate of misstatements accumulated during the audit approaches materiality (AU-C 450.06b) (see FAM 540) or
- if the nature of the identified misstatements and the circumstances of their occurrence indicate that other misstatements may exist that when aggregated with misstatements accumulated during the audit, could be material (AU-C 450.06a).

In addition, if material weaknesses or other significant deficiencies are identified, the auditor should consider their implications on this risk assessment.

.03 The auditor should update the fraud risk evaluation throughout the audit because evidence gathered later in the audit could change or support an earlier judgment about fraud risks. For example, the auditor may identify discrepancies in the accounting records or conflicting or missing evidence.

.04 The auditor should evaluate, at or near the end of the audit, whether the accumulated results of auditing procedures affect the assessment of the risks of material misstatement due to fraud made earlier in the audit or indicate a previously unrecognized risk of material misstatement due to fraud. In this case, the auditor should evaluate the need for additional or different audit procedures. If not already performed when forming an overall conclusion, the analytical procedures relating to revenue should be performed through the end of the reporting period (AU-C 240.34). The auditor should

- perform overall analytical procedures related to revenue, if revenue is (or is expected to be) material;

- evaluate whether overall analytical or other substantive procedures indicate a previously unrecognized fraud risk;
- evaluate whether responses to inquiries during the audit have been vague, implausible, or inconsistent with other evidence; and
- evaluate other evidence gathered during the audit.

.05 Based on these reassessments, the auditor should determine whether the nature, extent, and timing of substantive audit procedures were sufficient and appropriate, such as the sample sizes used in detail tests and the limit used for investigating differences identified in substantive analytical procedures. The auditor should document the determination and identify any additional procedures that should be performed. This documentation must be provided to the reviewer in a timely manner to allow any issues to be promptly identified and resolved.

.06 When the auditor determines whether an opinion can be expressed on the financial statements, the auditor should evaluate any limitations on the nature, extent, or timing of work performed. Additional guidance on scope limitations and their impact is provided in FAM 580.03 through .08. Also see FAM 545 for further evaluation of audit risk.

540 – Evaluate Effects of Misstatements on Financial Statements and Auditor's Reports

.01 The auditor might detect misstatements during substantive tests or other procedures. The auditor should communicate misstatements to management on a timely basis; accumulate misstatements identified during the audit, other than those that are clearly trivial (AU-C 450.05); and evaluate misstatements individually and in the aggregate in both quantitative and qualitative terms.

.02 Based on AU-C 450.A6, to assist in evaluating the effects of misstatements accumulated during the audit and in communicating misstatements to management, the auditor generally should use the following categories to classify each misstatement:

- **Factual misstatements.** Misstatements about which there is no doubt. These include identified factual misstatements arising from nonstatistical selections or other nonstatistical tests.
- **Judgmental misstatements.** Differences arising from the judgments of management, including those concerning recognition, measurement, presentation, and disclosure in the financial statements (including the selection or application of accounting policies), that the auditor considers unreasonable or inappropriate. These include identified judgmental misstatements arising from nonstatistical selections or other nonstatistical tests.
- **Projected misstatements.** The auditor's best estimate of the amount of the misstatements in populations, involving the projection of misstatements identified in statistical audit samples to the entire population from which the samples were drawn.

.03 For accounting estimates, based on AU-C 540.A139, if the audit evidence supports an auditor's point estimate that differs from management's point estimate, the difference between the auditor's point estimate and management's point estimate constitutes a misstatement. If the audit evidence supports a range that does not include management's point estimate, the auditor generally should include the difference between management's point estimate and the nearest point of the auditor's range as a judgmental misstatement. See FAM 905 for additional guidance on accounting estimates.

.04 FAM 475 (substantive analytical procedures) and FAM 480 (substantive detail tests) discuss the evaluation of individual misstatements from a quantitative standpoint.

If the auditor judges an individual misstatement to be material, the auditor generally should not offset other misstatements against it.[1] Following that guidance, the auditor should quantify the effects of the misstatement.

[1]For example, if assets have been materially overstated, the financial statements as a whole will be materially misstated, even if the effect of the misstatement on net position is completely offset by an equivalent overstatement of liabilities. It may be appropriate to offset misstatements within the same account balance or class of transactions; however, the risk that further undetected misstatements may exist is considered before concluding that offsetting even immaterial misstatements is appropriate. See AU-C 450.A26.

Communicate Misstatements to Management

.05 Based on AU-C 450.07, when the auditor detects misstatements during the audit, the auditor should, on a timely basis, take the following actions:

a. Communicate the misstatements, other than those that are clearly trivial, with the appropriate level of management.

b. Request that management adjust the entity's financial statements and underlying records to correct the misstatements.

.06 Management is responsible for determining whether the misstatements the auditor communicated are material to the entity's financial statements and determining whether to adjust the entity's financial statements and underlying records to correct the misstatements. If management does not correct the misstatements, the auditor should obtain an understanding of management's reasons for not making the corrections and whether the uncorrected misstatements are considered material. The auditor should take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement (AU-C 450.09).

.07 The auditor may request that management examine a line item, account, note disclosure, or class of transactions in order for management to understand the cause of a misstatement identified by the auditor; perform procedures to determine the amount of the actual misstatement in the line item, account, note disclosure, or class of transactions; and make appropriate adjustments to the financial statements (AU-C 450.A12).[2] The auditor should then test management's procedures and the amount of the proposed adjustment to determine the reasonableness of the amount. The auditor should perform additional audit procedures, if needed, to determine whether misstatements remain (AU-C 450.08).

When the auditor has identified a judgmental misstatement involving differences in estimates, such as a difference in a fair value estimate, the auditor may request management to review the assumptions and methods used in developing management's estimate (AU-C 450.A14).

.08 If management disagrees with the auditor's judgmental and projected misstatements, and if the disagreement involves amounts that are material, the auditor should again request that management perform procedures, such as reviewing all or substantially all of the items in the relevant population, to determine its own estimated amount of the misstatement and provide more assurance as to the auditor's estimate, if the entity has not yet done so. If the entity determines its own estimate of the misstatement, the auditor should test management's procedures and conclusions and determine whether additional audit procedures are necessary.

If management refuses to perform the necessary investigation, the audit director may decide not to expend additional time and audit resources to resolve the

[2]Such a request may be made, for example, based on the auditor's projection of misstatements identified in an audit sample to the entire population from which it was drawn. Management may establish valuation allowances for projected misstatements, net of factual misstatements (since the projected misstatement represents the best estimate of the total correction needed). Generally, entities resist booking projected misstatements citing no supporting transactions. However, the amount can be booked through a general journal entry and reversed the following year.

disagreement because, for example, additional testing is unlikely to provide different conclusions.

If the auditor believes that the auditor's estimate is sufficiently accurate, the auditor should express a qualified or adverse opinion, depending on the materiality and pervasiveness of the item to the financial statements as a whole (see FAM 580.43). If the auditor believes that the auditor's estimate is not sufficiently accurate, the auditor should express a qualified or disclaimer of opinion for a scope limitation, depending on the materiality and pervasiveness of the item to the financial statements as a whole.

The auditor should document an overall evaluation, including decisions reached, of any management disagreement with the misstatements.

Accumulate Misstatements

.09 To evaluate the aggregate effects of misstatements on the financial statements, the auditor should accumulate misstatements identified during the audit, other than those that are clearly trivial (AU-C 450.05) (see FAM 595 C for details and examples on accumulating misstatements).

.10 The auditor should accumulate individual misstatements that management chose not to correct, including any nontrivial misstatements that management brings to the auditor's attention that management has not corrected. The auditor should quantify and evaluate uncorrected misstatements on the financial statement line items under both the balance sheet and net cost approaches.[3]

- The **balance sheet** approach quantifies a misstatement with the objective of making the balance sheet correct as of the end of the current year.
- The **net cost approach** quantifies a misstatement with the objective of making the current year statement of net cost correct.

The auditor should prepare the list of adjusting entries needed to correct the uncorrected misstatements and accumulate the entries on the summary of uncorrected misstatements (SUM). See FAM 595 C for details on accumulating misstatements, including examples for each approach, and an example SUM and corresponding list of adjusting entries needed to correct the uncorrected misstatements.

.11 The auditor should also accumulate misstatements that the auditor has identified and management has corrected on the summary of corrected misstatements. (See FAM 595 C, example 2 for an example of the summary of corrected misstatements.)

.12 If the entity presents comparative financial statements, the auditor should also update, as appropriate, the list of adjusting entries needed to correct the uncorrected misstatements and SUM corresponding to the prior period. If, during the current period audit, the auditor detects a misstatement, other than clearly trivial, affecting the prior period financial statements that was not previously detected, the auditor should bring it to management's attention and update the list of adjusting entries needed to correct the uncorrected misstatements and

[3]The balance sheet and net cost approaches are also known as iron curtain and rollover approaches, respectively. The auditor considers the effect of misstatements on all financial statements under each of these approaches.

SUM for the prior period to incorporate those misstatements. The auditor should also update, as appropriate, the prior year list of adjusting entries needed to correct the uncorrected misstatements and SUM for any other changes based on updated information. The auditor should determine if the misstatement, together with other uncorrected misstatements, is material to the prior-period and current-period financial statements. Also see FAM 580.110 regarding financial statement restatements.

.13 The auditor should also accumulate uncorrected misstatements (including omissions), other than those that are clearly trivial, on the notes to the entity's financial statements on a quantitative and qualitative basis.

Quantitative misstatements, including omissions, in note disclosures include (1) a material misstatement of an amount in the note disclosure and (2) the misclassification of a material amount between subcategories of the line item total.

When determining whether qualitative note disclosures may be material, each individual misstatement, including omissions, is considered (based on size, nature, or circumstances) to evaluate its effect on the relevant note disclosures, as well as its overall effect on the financial statements as a whole. The determination of whether a misstatement in a qualitative note disclosure is material, in the context of the applicable financial reporting framework (generally U.S. GAAP) and the specific circumstances of the entity, is a matter that involves the exercise of professional judgment. Examples of misstatements that may be material include

- inaccurate or incomplete descriptions of information about the objectives, policies, and processes for managing budgetary resources;
- the omission of information about the events or circumstances that have led to an impairment loss;
- incorrect description of an accounting policy relating to a significant item in any of the statements that the financial statements comprise; and
- an inadequate description of the sensitivity of an exchange rate. (AU-C 450.A23)

.14 The auditor should communicate the uncorrected misstatements accumulated on the SUM with management. Providing the SUM to management can assist management in understanding the potential aggregate effect of misstatements on the financial statements. Management is responsible for determining whether the uncorrected misstatements on the SUM are material, individually or in the aggregate, to the entity's financial statements under either the net cost or balance sheet approaches and whether to make any further adjustments to the financial statements. If management makes any further adjustments to correct the misstatements accumulated on the SUM, the auditor should update the (1) list of adjusting entries needed to correct the uncorrected misstatements, (2) SUM, and (3) summary of corrected misstatements.

.15 In presenting the misstatements to management, the auditor generally should remind management that AU-C 580, *Written Representations*, requires the entity to provide written representations in the management representation letter about whether it believes the effect of uncorrected misstatements aggregated by the auditor, both individually and in the aggregate, are immaterial to the financial

statements as a whole. AU-C 580 also requires that a summary of the uncorrected misstatements be attached to the representation letter. Attaching this summary is further discussed in FAM 1001.

Evaluate Misstatements

.16 The auditor should evaluate the effects of both uncorrected and corrected misstatements on the financial statements and notes.

.17 When determining whether uncorrected misstatements are material, either individually or in the aggregate, to the financial statements and notes, the auditor should consider the

- size and nature of the misstatements, both in relation to particular line items, accounts, note disclosures, or classes of transactions in the financial statements and in relation to the financial statements as a whole, and the particular circumstances of their occurrence, and
- effect of uncorrected misstatements related to prior periods on line items, accounts, note disclosures, or classes of transactions and the financial statements as a whole (AU-C 450.11).

If the auditor provides assurance on any combining statements and supplemental schedules in relation to the financial statements as a whole, the auditor should determine whether these statements and schedules are materially misstated due to uncorrected misstatements. See AU-C 725 for guidance on reporting on supplementary information.

.18 If the total of uncorrected misstatements is material, the auditor should modify the opinion on the financial statements (see FAM 580.09). Deciding how to modify the opinion, based on the materiality and pervasiveness of the uncorrected misstatements, involves significant auditor judgment. The decision and its basis should be documented. The audit director should be involved in the decision and review the documentation related to it. Also, the related documentation must be provided to the reviewer in a timely manner to allow any issues to be promptly identified and resolved.

Misstatements, either individually or in the aggregate, are material if, in light of surrounding circumstances, it is probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the correction of the items. The concept of materiality includes both quantitative and qualitative considerations, as further discussed in FAM 230 and FAM 545.

.19 Although there is a point at which total uncorrected misstatements would generally be considered material, there is no single amount that can be used for the auditor's decision to modify the opinion. The auditor should follow a process that considers various factors in reaching this decision. See FAM 545, if applicable.

.20 The auditor should also conclude on the adequacy of the scope of procedures performed in light of the total corrected and uncorrected misstatements identified (see FAM 530 and 545). The auditor's conclusion must be provided to the reviewer in a timely manner to allow any issues to be promptly identified and resolved.

.21 The auditor should determine whether the overall audit strategy and audit plan need to be revised if

- the nature of all identified misstatements (corrected and uncorrected) and the circumstances of their occurrence indicate possible undetected misstatements that, when aggregated with misstatements accumulated during the audit, could be material or
- the aggregate of all misstatements accumulated during the audit approaches materiality as discussed in FAM 530 (AU-C 450.06).

.22 In addition to evaluating the effects of all misstatements (corrected and uncorrected) on the financial statements and notes, the auditor should evaluate the effects of misstatements on the following:

a. The auditor's conclusions on internal control (see FAM 580.56–.85).

   The auditor should determine whether the misstatements indicate control deficiencies that had not been previously identified, whether the assessment of control risk at the assertion level remains appropriate, whether audit procedures are appropriate in light of any revisions to this assessment, and whether the categorization of control deficiencies for reporting purposes is appropriate (whether they are material weaknesses or other significant deficiencies).

b. The consideration of the risks of material misstatement (see FAM 530).

   The auditor should determine whether the misstatements indicate the assessment of risk of material misstatement (combined inherent risk and control risk) remains appropriate and whether audit procedures are appropriate in light of any revisions to this assessment.

c. The auditor's evaluation of the financial management systems' substantial compliance with the three FFMIA requirements, if applicable (see FAM 580.86–.90).

   The auditor should evaluate the effects of misstatements on the auditor's conclusions with respect to the financial management systems' substantial compliance with the three FFMIA requirements.

d. The entity's compliance with significant provisions of applicable laws, regulations, contracts, and grant agreements (see FAM 580.91–.99).

   The auditor should evaluate the effects of misstatements on the auditor's conclusions with respect to the entity's compliance with significant provisions of applicable laws, regulations, contracts, and grant agreements.

e. Budget formulation and execution.

   The auditor should evaluate the effects the misstatements have on budget-related matters for purposes of reporting budget control deficiencies, reporting on the statement of budgetary resources and reconciliation of net cost to net outlays,[4] and reporting on compliance with applicable budget-related provisions of laws and regulations.

f. Other reports.

[4]Per OMB reporting guidance, the reconciliation of net cost to net outlays may be presented as a financial statement or note to the financial statements.

The auditor should consider whether to report the potential effects of the misstatements and any related control deficiencies on other reports prepared by the entity that are (1) used for management decision-making or (2) distributed outside the entity.

Qualitative Considerations

.23 The auditor should also evaluate appropriate qualitative aspects when determining the effect of uncorrected misstatements on the auditor's report. The circumstances related to some misstatements may cause the auditor to evaluate them as material, individually or when considered together with other misstatements accumulated during the audit, even if they are quantitatively lower than materiality for the financial statements as a whole. Circumstances that may affect the evaluation include the extent to which a misstatement has the following attributes:

a. Is considered sensitive to financial statement users, that is, the Congress, the public, influential special interest groups, and interested foreign governments.

b. Offsets other misstatements in the aggregate but is individually significant.

c. Has a significant effect on the RSI (including the MD&A presented by management) and other information.

d. Affects compliance with laws and regulations.

e. Affects compliance with contracts or grant agreements.

f. Relates to the incorrect selection or application of an accounting policy that has an immaterial effect on the current period's financial statements but is likely to have a material effect on future periods' financial statements.

g. Affects segment information presented in the financial statements (for example, the significance of the matter to a segment or other portion of the entity's business that has been identified as playing a significant role in the entity's operations or profitability).

h. Represents an omission of information not specifically required by the applicable financial reporting framework (generally U.S. GAAP) but that in the professional judgment of the auditor is important to the users' understanding of the financial position, financial performance, or cash flows of the entity.

i. Affects other information that will be communicated in the annual report (for example, information to be included in an MD&A) when there is a substantial likelihood that the other information would influence the judgment made by a reasonable user based on the financial statements.

j. Is currently immaterial but is likely to have a material effect in future periods because of a cumulative effect, for example, that builds over several periods.

k. Is too costly to correct. It may not be cost beneficial for the entity to develop a system to calculate a basis to record the effect of an immaterial misstatement. On the other hand, if management appears to have developed a system to calculate an amount that represents an immaterial misstatement, it may reflect a motivation of management.

l. Represents a risk that possible additional undetected misstatements would affect the auditor's evaluation.

m. Changes a loss into income or vice versa.

n. Heightens the sensitivity of the circumstances surrounding the misstatement (for example, the implications of misstatements involving fraud, conflicts of interest, or noncompliance with laws, regulations, contracts, or grant agreements).

o. Relates to the definitive character of the misstatement (for example, the precision of an error that is objectively determinable as contrasted with a misstatement that unavoidably involves a degree of subjectivity through estimation, allocation, or uncertainty).

p. Indicates the motivation of management (for example, (1) an indication of a possible pattern of bias by management when developing and accumulating accounting estimates, (2) a misstatement precipitated by management's continued unwillingness to correct weaknesses in the financial reporting process, or (3) an intentional decision not to follow the applicable financial reporting framework (generally U.S. GAAP)).

q. Involves proprietary or sensitive information, such as protected health information, federal taxpayer information, or classified national security information.

r. Affects financial markets, the U.S. economy, or political decisions, such as controversial pending legislation or an upcoming election.

s. Indicates selective correction by management of certain misstatements brought to its attention during the audit (for example, correcting misstatements with the effect of increasing reported earnings but not correcting misstatements that have the effect of decreasing reported earnings).

These circumstances are only examples—not all are likely to be present in all audits nor is the list necessarily complete. The existence of any circumstances such as these does not necessarily lead to a conclusion that a misstatement is material. See AU-C 450.A28 for further examples.

Evaluate Whether Identified Misstatements Indicate Fraud

.24 The auditor should evaluate whether identified misstatements might indicate fraud. If such an indication exists, the auditor should evaluate the implications of the misstatement with regard to other aspects of the audit, particularly the auditor's evaluation of materiality, management and employee integrity, and the reliability of management representations, recognizing that an instance of fraud is unlikely to be an isolated occurrence (AU-C 240.35). If, preliminarily, the auditor believes that a misstatement is or might be the result of fraud, the auditor should discuss this with the audit director, who should determine whether to seek assistance from the Special Investigator Unit or the Office of the General Counsel (OGC). If performing the audit under contract, the auditor should consult with the Assistant Inspector General for Audit or the GAO managing director who has responsibility for the audit.

If, on the basis of evidence obtained, the auditor believes that an instance of fraud (or significant abuse) has occurred or is likely to have occurred, the auditor should

- consult with the Special Investigator Unit and OGC (or if performing the audit under contract, consult with the Assistant Inspector General for Audit or the GAO managing director),
- include relevant information in the audit report unless the instance is clearly inconsequential, and
- determine that those charged with governance are adequately informed.

If the auditor has identified or suspects fraud, the auditor should determine whether the auditor has a responsibility to report the occurrence or suspicion to a party outside the entity. Although the auditor's professional duty to maintain the confidentiality of client information may preclude such reporting, the auditor's legal responsibilities may override the duty of confidentiality in some circumstances (AU-C 240.42 and GAGAS (2018) 6.53–6.56). In some circumstances, the auditor may be required by law or regulation to report directly to outside parties about fraud (or significant abuse). The auditor may limit public reporting to matters that would not compromise any related investigative or legal proceedings (GAGAS (2018) 6.49).

.25 If a misstatement is or might be the result of fraud and the effect is not material to the financial statements, the auditor should evaluate the implications, especially those regarding the organizational position and responsibilities of the individual involved. If the matter involves a relatively low-level employee who is not responsible for significant activities (for example, a misappropriation from a small petty cash fund by a nonmanagement employee), the auditor may conclude that the matter has little significance to the audit. However, if the auditor identifies a misstatement, whether material or not, and the auditor has reason to believe that it is, or may be, the result of fraud and that management (in particular, senior management) is involved, the auditor should reevaluate the assessment of the risks of material misstatement due to fraud and its resulting effect on the nature, timing, and extent of audit procedures (AU-C 240.36). The auditor should evaluate whether the misstatement is qualitatively material or might indicate a more pervasive problem.

The auditor should also consider whether circumstances or conditions indicate possible collusion involving employees, management, or third parties when reconsidering the reliability of evidence previously obtained (AU-C 240.36). Regardless of the level of the employee involved, the auditor should report the potential fraud to at least the next level of management. In addition, the auditor should reach an understanding with those charged with governance regarding the nature and extent of communications with them about fraud perpetrated by lower-level employees.

.26 If a misstatement is or might be the result of fraud and either the effect could be material or the auditor is unable to determine whether the effect is material, the auditor should

- attempt to obtain additional evidential matter to determine whether material fraud has occurred or is likely to have occurred and its effect on the financial statements and the related audit report;
- evaluate the implications for other aspects of the audit, including reevaluating the assessment of risks and the resulting effects on testing, as described in the preceding paragraph (AU-C 240.35 and .36);

- discuss the matter and the approach for further investigation with at least the next higher level of management and with senior management and those charged with governance; and
- determine whether to advise management to consult with its legal counsel.

.27 As discussed in AU-C 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, the auditor should not assume that an instance of fraud or error is an isolated occurrence and therefore should evaluate how the detection of the misstatement affects the risks of material misstatement, including (1) the related nature, extent, and timing of substantive audit procedures and (2) the audit evidence of the operating effectiveness of relevant controls, including the entity's risk assessment and monitoring process.

.28 Depending on the circumstances, fraud (material or immaterial) could affect the quality of management's representations and the auditor's reports on the financial statements; internal control over financial reporting; and compliance with significant provisions of applicable laws, regulations, contracts, and grant agreements. The auditor must discuss with the reviewer the significant judgments and conclusions made by the engagement team with respect to fraud in a timely manner to allow any issues to be promptly identified and resolved.

545 – Audit Exposure (Further Evaluation of Audit Risk)

.01 At the beginning of the audit, performance materiality (which, as defined, is one or more amounts) was set to reduce to an appropriately low level the probability that the aggregate of uncorrected and potential undetected misstatements in the financial statements exceeds materiality for the financial statements as a whole (AU-C 320.09). Before the conclusion of the audit, the auditor should consider any potential further misstatement to the financial statements as a whole by accumulating the total of uncorrected misstatements plus an overall allowance for undetected misstatements.

If the aggregate of misstatements accumulated during the audit approaches materiality, a greater than acceptably low level of risk may exist that possible undetected misstatements, when taken with the aggregate of uncorrected misstatements accumulated during the audit, could exceed materiality (AU-C 450.A8). It is important to evaluate the potential further misstatement amount in relation to materiality for the financial statements as a whole (see FAM 230.06) and the relative importance of the misstated items to readers of the financial statements (qualitative and mitigating aspects). Therefore, the auditor should determine whether its audit exposure (i.e., combination of detected misstatements, possible undetected misstatements, and qualitative aspects) is material to the financial statements.

Evaluation

.02 The auditor may or may not detect misstatements during substantive tests or other procedures performed during the audit (see FAM 540). However, the auditor should evaluate the risk of potential undetected misstatement, which is due to the imprecision of audit procedures. This risk includes such things as the following:

a. Unaudited amounts/accounts that were considered to be individually immaterial and were not tested on that basis (untested amounts). The auditor should include all untested amounts/accounts, including those that are clearly trivial. All untested amounts are considered to be 100 percent overstated for this evaluation. Further, if the auditor believes there is a risk of material understatement, the auditor should include the amount of potential understatement (if the amount is not quantifiable, see FAM 545 A.20).

b. The sampling precision associated with statistical samples selected for substantive tests of financial statement balances.[5]

c. If no statistical samples are selected, an allowance for possible undetected misstatements equal to performance materiality.

d. An allowance for the imprecision of substantive analytical procedures on which the auditor placed complete reliance.

Totaling the amounts from these aspects with any uncorrected misstatements (see FAM 540) provides a conservative quantitative estimate of the potential amount of misstatement to the financial statements as a whole, which affects

[5]An audit sampling specialist may perform or be consulted on all statistical calculations.

audit exposure. For example, if the aggregate uncorrected misstatement is $10 million and the allowance for imprecision of audit procedures is probably no more than $5 million, the auditor should determine whether the total of $15 million could materially misstate the financial statements as a whole.

.03 For any notes to the financial statements containing misstatements (other than those that are clearly trivial quantitatively or qualitatively) or for which there is a risk of significant potential undetected misstatements, the auditor should assess the significance of and document any such misstatements and potential undetected misstatements.

.04 The auditor may also consider any other aspects that may increase the risk of potential undetected misstatements and also consider any mitigating factors that may lower the risk of misstatement.

.05 The auditor's evaluation of audit exposure must be provided to the reviewer in a timely manner to allow any issues to be promptly identified and resolved. See FAM 545 A for a template that the auditor can use to perform this evaluation.

545 A – Further Evaluation of Audit Risk Template

.01 This template is a tool that the auditor can use to conduct the analysis described in FAM 545. The template consists of four sections: (I) Conclusions, (II) Consideration of Quantitative Factors, (III) Consideration of Notes to the Financial Statements, and (IV) Consideration of Other Factors. In each section, blank rows may be used, and if needed, more rows added for additional factors specific to any given audit.

Consideration of Quantitative Factors

Overall

.02 Amounts that do not affect the materiality (benchmark) will be entered to column C for each financial statement in the tables below.

a. Untested amounts and allowance for the imprecision of analytical procedures on which complete substantive reliance was placed (see FAM 470.09) will be entered at absolute value (simple addition with no +/- signs).

b. Uncorrected misstatements that do not affect the benchmark will first be netted for each line item, and then the amount for all the line items will be accumulated at absolute value and the total entered to column C.

c. Sampling precision associated with statistical samples selected to test balances that do not affect the benchmark will be statistically combined, as appropriate, with the assistance of the audit sampling specialist, and the result entered to column C. For any financial statement on which the benchmark does not appear, all amounts will be entered to column C. Hence, in such cases, column D will not be needed, and “N/A” can be entered in each row. Amounts related to balances that do affect the benchmark will be entered in column D. In these cases, untested amounts, limits related to analytical tests upon which we placed 100 percent substantive reliance, and uncorrected misstatements will all be added or netted, as appropriate, to determine their actual effect on the benchmark and the results entered in column D.

Combined sampling precision calculations related to balances that do affect the benchmark will be done the same way as for those balances that do not affect the benchmark (above), except that they will be entered in column D. So, on any financial statement that includes the benchmark and also reports a mixture of balances that do, and do not, affect the benchmark (and were subject to statistical sampling), two separate sample combination calculations will be needed—one for column C and one for column D. To illustrate some of these principles:

- If the designated materiality benchmark is total assets, only the balance sheet will use column D at all because total assets does not appear on any other financial statement. On the balance sheet itself, the net exposure amount (debits less credits) to assets will appear in column D because it affects total assets. However, the amount of exposure to liabilities will be calculated separately at absolute value (rather than net value) and entered in column C because it does not affect total assets.

- If the designated materiality benchmark is net position, the balance sheet and the statement of changes in net position will both only use column D because both statements include net position, and all of their line items affect it. Hence, in both cases, column C will not be used, and "N/A" can be entered in each row. On all other financial statements, net position does not appear, and hence, the reverse will be true: Column D will be N/A, and only column C will be used. Because both assets and liabilities affect net position, the amount of exposure to each will be netted as described above and entered in column D for untested amounts, analytical limits, and uncorrected misstatements to arrive at the amount to the benchmark.

.03 **Use of column C.** Calculate the net uncorrected misstatements for each individual line item, as indicated above, and enter the result where directed. For all other amount elements, calculate the absolute value (eliminate +/- signs and add them up) of all individual amounts, and enter the result where directed. For example, if you have a $50 untested liability, and a $20 untested asset, you enter $70 on the untested amounts line. Similarly, if you have a total reliance analytical procedures limit of $30 related to one liability line item, and a $60 total reliance on analytical procedures limit related to another liability line item, you enter $90 as the related amount. Because it is absolute value, debit/credit, asset/liability, and cost/revenue distinctions are irrelevant; remove the +/- signs and add them up. Combined sampling precision calculations generally should be performed by the audit sampling specialist. Auditors will need to identify situations where a financial statement includes both balances that do, and do not, affect the materiality benchmark. If both types of line items conditions exist and both were subject to statistical sampling, separate sample combination calculations would become necessary for each, so that the results can be split between columns C and D.

.04 **Use of column D.** Calculate the net effect (debits less credits) of each factor on the materiality benchmark, as described above, and enter the result. The question of what affects the benchmark depends on what benchmark is selected. For example, assume that the selected materiality benchmark on the balance sheet is total assets, and you have four untested asset amounts totaling $50, and two allowances (contra-assets) totaling $40—you net the two against each other, and enter $10 on the untested amounts line as the potential undetected misstatement. Combined sampling precision calculations would be done the same way, except that auditors will need to identify whether there are tests of balances that do, and do not, affect the materiality benchmark. If multiple line items were subject to statistical sampling, separate sample combination calculations would become necessary for each, so that the results can be split between columns C and D.

.05 Do not separately calculate an exposure amount for financial statement line items, such as subtotals and totals, cumulative results of operations, and net position, as the amount of exposure related to these is shown elsewhere.

.06 On the statement of budgetary resources (SBR), audit exposure will be calculated separately for each of its sections. Within each of the three sections, the results of all statistical samples selected will be statistically combined, as appropriate, which generally should be done with the assistance of the audit sampling specialist.

Evaluation of Uncorrected Misstatements

.07 For each line item of each financial statement, calculate the net effect (debits less credits) of uncorrected misstatements, if any. Include only the misstatements from nonstatistical selections or other nonstatistical tests (factual and judgmental). The estimated effect of the outcome of statistical tests will be included in the sampling precision calculations below.

.08 For uncorrected misstatements that do not affect the materiality benchmark, calculate the absolute value of the amounts calculated above for each financial statement (i.e., once you have calculated the net effect on each line item, remove the +/- signs for the totals and add them up). Enter the result in the appropriate space under column C for each financial statement.

.09 For uncorrected misstatements that affect the materiality benchmark, calculate the net effect on the materiality benchmark of all uncorrected misstatements (net the debits and the credits). Enter the result in the appropriate space under column D for each financial statement.

Evaluation of Potential Undetected Misstatements

Untested Amounts

.10 For untested amounts that do not affect the materiality benchmark, calculate the absolute value of the untested amounts, and enter the result in the appropriate space under column C, for each financial statement.

.11 For untested amounts that affect the materiality benchmark, calculate the net effect on the materiality benchmark of all untested amounts (net the debits and credits). Enter the result in the appropriate space under column D for each financial statement. See FAM 545 A.04 for an example.

Sampling Precision—Monetary Unit Samples (MUS) and Non-MUS Samples

.12 For statistical sample(s) selected to test line items that do not affect the materiality benchmark, calculate and enter the combined sampling precision for each financial statement in the appropriate space under column C.

.13 For statistical samples selected to test line items that affect the materiality benchmark, calculate and enter the combined sampling precision for each financial statement in the appropriate space under column D. Assess this amount to the financial statement as a whole qualitatively.

.14 If no statistical sampling was performed, enter the performance materiality in column D.

Allowance for Imprecision of Analytical Procedures on Which Complete Substantive Reliance Was Placed

.15 For each financial statement, identify analytical procedures upon which complete substantive reliance was placed (see FAM 470.09). Include an allowance for the imprecision of these procedures (i.e., potential undetected misstatement) based on the following scenarios:

- **Scenario (a):** The limit set is not exceeded by the observed difference between the expected and actual outcome. Include the amount of the difference between the expected and actual outcome. If the auditor elects to

investigate the difference even though it is not necessary in the circumstances, do not include any portion of the difference for which the auditor has obtained a reasonable and supported explanation.

Example: We projected a final balance of $1 million and set a limit of $200,000. The reported balance was actually $900,000. Since the difference between the reported balance and our projected balance ($100,000) is within the limit we set ($200,000), we did not investigate. The amount of potential undetected misstatement in this case would be $100,000, which is the difference we did not investigate between the reported balance ($900,000) and the projected balance ($1 million).

- **Scenario (b):** The limit set is exceeded by the observed difference between the expected and actual outcome. Include the amount of the limit. As in scenario (a), do not include any portion of the limit for which the auditor has obtained a reasonable and supported explanation. The auditor would propose an audit adjustment for the portion of any unexplained difference exceeding the limit, and if management rejects the proposed audit adjustment, the auditor would treat that portion as an uncorrected misstatement (see FAM 545 A.07–A.09 above).

  Example: We set the limit at $50,000, the projected balance is $900,000, and the reported balance is $1,100,000. The difference between the reported balance ($1,100,000) and our projected balance ($900,000) is $200,000, which exceeds our limit ($50,000), so we investigated but without success. We would propose an audit adjustment $150,000, which is the extent to which the unexplained difference exceeds the limit. If the entity accepts and posts the audit adjustment, the potential undetected misstatement would be $50,000, which is the remaining portion of the unexplained difference that we did not investigate and the entity did not correct. If the entity does not accept the proposed audit adjustment, the audit difference would be $200,000. Of this difference, $50,000 would be treated as a potential undetected misstatement and $150,000 (the rejected adjustment) would be treated as an uncorrected misstatement.

.16 For any such analytical procedures affecting line items that do not affect the materiality benchmark, calculate the absolute value of all potential undetected misstatements identified above, and enter the result in the appropriate space under column C, for each financial statement.

.17 For any such analytical procedures affecting line items that affect the materiality benchmark, calculate the net effect of all potential undetected misstatements identified above, and enter the result in the appropriate space under column D, for each financial statement.

.18 For consideration of the implications of any analytical procedures on which we placed only partial substantive reliance, see section IV, Consideration of Other Factors.

Consideration of Notes to the Financial Statements

.19 For any note to the financial statements containing misstatements (other than those that are clearly trivial quantitatively or qualitatively) or for which there is a risk of significant potential undetected misstatements (e.g., untested amounts, imprecision of amounts or audit testing, or note disclosures omitted due to

immateriality), assess the significance of and document any such misstatements and potential undetected misstatements (e.g., identifying the note number and name, a description of the misstatement or potential misstatement, and qualitative and quantitative factors considered). Include a misstatement in section III to the extent that the misstatement is not fully considered in section II. For example, include the information in section III if it relates to a disaggregation of a line item (e.g., property, plant, and equipment) in the note. Index to appropriate support.

Consideration of Other Factors

.20 Consider the (1) imprecision of analytical procedures on which only partial reliance was placed, (2) audit exposure affecting amounts in the financial statements that do not affect the materiality benchmark when considered in relation to the total of the amounts they directly affect, (3) implications of corrected misstatements (e.g., potential existence of further undetected misstatements), and (4) other factors. Index to appropriate support.

Section I: Conclusions

This section contains example language. The auditor should tailor the language, as appropriate, to the specific circumstances of the audit.

Purpose

To determine if our audit exposure (i.e., combination of detected misstatements, possible undetected misstatements, and qualitative aspects) is material to the financial statements.

Approach

We analyzed quantitative and qualitative factors potentially affecting our audit risk. The calculated measurable quantitative amounts for each financial statement **(section II)** represents the total value of (1) the net amount of correcting audit adjustments that were not accepted and booked by XYZ entity; (2) amounts that were considered to be individually immaterial and were not tested on that basis (untested amounts); (3) the sampling precision associated with statistical samples selected for the purposes of performing substantive tests of financial statement balances; (4) if no statistical sampling was performed, an allowance equal to performance materiality; and (5) an allowance for the imprecision of substantive analytical procedures on which we placed total reliance. Our analysis was designed to provide a conservative estimate of the risk represented by these conditions and therefore used conservative assumptions. For example, all untested amounts were considered to be 100 percent overstated. All statistical calculations were performed by or in consultation with an audit sampling specialist. We assessed the significance of misstatements and potential undetected misstatements affecting the notes to the financial statements to the extent not fully considered in **section II** and have documented our assessment in **section III**. We also considered whether other factors were relevant or potentially significant to our evaluation of audit risk. This includes factors that may affect risk but whose actual dollar effect cannot be measured with any degree of precision. These are documented in **section IV.**

Materiality Benchmark(s)

We determined that the materiality benchmark was total gross costs because, based upon our judgment, we concluded that it is the most significant element of XXX's financial statements to users (FAM 230). During the planning phase of the audit, we used XXX's reported $300 million in total gross costs for fiscal year 2023 to calculate our performance materiality and tolerable misstatement thresholds. As XXX's actual total program costs of $315 million for fiscal year 2024 exceeded the prior-year amount used in the planning phase calculations, we believe that the performance materiality and tolerable misstatement thresholds used are adequate. Additionally, we assessed the adequacy of our determination to apply the materiality benchmark to each financial statement given the effect of identified misstatements on the various financial statements and line items; we determined that the application of the benchmark was valid.

Sources

As indexed in sections II, III, and IV.

Conclusions

Based on considerations of both the quantitative and qualitative aspects of the audit exposure in this analysis, including the effect of amounts not directly affecting the materiality benchmark, we believe that the audit exposure is immaterial.

Section II: Consideration of Quantitative Factors

BALANCE SHEET			
A	**B**	**C**	**D**
		Estimated Amounts	
Audit Exposure (Quantitative)	**Doc. Ref.**	Absolute Value Effect of Factors Not Directly Affecting the Materiality Benchmark	Net Effect of Factors Directly Affecting the Materiality Benchmark, on the Materiality Benchmark
Factual Uncorrected Misstatements:[1]		$0	$0
Judgmental Uncorrected Misstatements:		0	0
Subtotal: Factual and Judgmental Uncorrected Misstatements		**$0**	**$0**
Estimate of Potential Undetected Misstatements:			
Untested Amounts		0	0
Combined Sampling Precision; Non-MUS Sample(s)		0	0
Combined Sampling Precision; MUS Sample(s)		0	0
[Include Performance Materiality amount if no statistical sampling was performed (and therefore no global upper error limit amount was included in the two rows above)]		0	0
Allowance for Imprecision of Analytical Procedures on Which Complete Substantive Reliance Was Placed		0	0
Other[2]		0	0
Subtotal: Estimated Quantitatively Measurable Undetected Misstatements		**$0**	**$0**
Total Estimated Quantitatively Measurable Misstatements		**$0**	**$0**
Materiality Benchmark ($ amount and benchmark used)		**[Add $ amount of benchmark used here]**	**[Describe benchmark used (total assets, total cost, etc.)]**
Total Estimated Quantitatively Measurable Misstatements as a Percentage of Materiality Benchmark		**0.0%**	**0.0%**
[Add auditor's note regarding the auditor's assessment of the percentage.]			

STATEMENT OF NET COST			
A	**B**	**C**	**D**
		Estimated Amounts	
Audit Exposure (Quantitative)	**Doc. Ref.**	Absolute Value Effect of Factors Not Directly Affecting the Materiality Benchmark	Net Effect of Factors Directly Affecting the Materiality Benchmark, on the Materiality Benchmark
Factual Uncorrected Misstatements:[1]		$0	$0
Judgmental Uncorrected Misstatements:		0	0
Subtotal: Factual and Judgmental Uncorrected Misstatements		**$0**	**$0**
Estimate of Potential Undetected Misstatements:			
Untested Amounts		0	0
Combined Sampling Precision; Non-MUS Sample(s)		0	0
Combined Sampling Precision; MUS Sample(s)		0	0
[Include Performance Materiality amount if no statistical sampling was performed (and therefore no global upper error limit amount was included in the two rows above)]		0	0
Allowance for Imprecision of Analytical Procedures on Which Complete Substantive Reliance Was Placed		0	0
Other[2]		0	0
Subtotal: Estimated Quantitatively Measurable Undetected Misstatements		**$0**	**$0**
Total Estimated Quantitatively Measurable Misstatements		**$0**	**$0**
Materiality Benchmark ($ amount and benchmark used)		**[Add $ amount of benchmark used here]**	**[Describe benchmark used (total assets, total cost, etc.)]**
Total Estimated Quantitatively Measurable Misstatements as a Percentage of Materiality Benchmark		**0.0%**	**0.0%**
[Add auditor's note regarding the auditor's assessment of the percentage.]			

STATEMENT OF CHANGES IN NET POSITION			
A	**B**	**C**	**D**
		Estimated Amounts	
Audit Exposure (Quantitative)	**Doc. Ref.**	Absolute Value Effect of Factors Not Directly Affecting the Materiality Benchmark	Net Effect of Factors Directly Affecting the Materiality Benchmark, on the Materiality Benchmark
Factual Uncorrected Misstatements:[1]		$0	$0
Judgmental Uncorrected Misstatements:		0	0
Subtotal: Factual and Judgmental Uncorrected Misstatements		**$0**	**$0**
Estimate of Potential Undetected Misstatements:			
Untested Amounts		0	0
Combined Sampling Precision; Non-MUS Sample(s)		0	0
Combined Sampling Precision; MUS Sample(s)		0	0
[Include Performance Materiality amount if no statistical sampling was performed (and therefore no global upper error limit amount was included in the two rows above)]		0	0
Allowance for Imprecision of Analytical Procedures on Which Complete Substantive Reliance Was Placed		0	0
Other[2]		0	0
Subtotal: Estimated Quantitatively Measurable Undetected Misstatements		**$0**	**$0**
Total Estimated Quantitatively Measurable Misstatements		**$0**	**$0**
Materiality Benchmark ($ amount and benchmark used)		**[Add $ amount of benchmark used here]**	**[Describe benchmark used (total assets, total cost, etc.)]**
Total Estimated Quantitatively Measurable Misstatements as a Percentage of Materiality Benchmark		**0.0%**	**0.0%**
[Add auditor's note regarding the auditor's assessment of the percentage.]			

STATEMENT OF BUDGETARY RESOURCES – BUDGETARY RESOURCES			
A	**B**	**C**	**D**
		Estimated Amounts	
Audit Exposure (Quantitative)	**Doc. Ref.**	Absolute Value Effect of Factors Not Directly Affecting the Materiality Benchmark	Net Effect of Factors Directly Affecting the Materiality Benchmark, on the Materiality Benchmark
Factual Uncorrected Misstatements:[1]		$0	$0
Judgmental Uncorrected Misstatements:		0	0
Subtotal: Factual and Judgmental Uncorrected Misstatements		**$0**	**$0**
Estimate of Potential Undetected Misstatements:			
Untested Amounts		0	0
Combined Sampling Precision; Non-MUS Sample(s)		0	0
Combined Sampling Precision; MUS Sample(s)		0	0
[Include Performance Materiality amount if no statistical sampling was performed (and therefore no global upper error limit amount was included in the two rows above)]		0	0
Allowance for Imprecision of Analytical Procedures on Which Complete Substantive Reliance Was Placed		0	0
Other[2]		0	0
Subtotal: Estimated Quantitatively Measurable Undetected Misstatements		**$0**	**$0**
Total Estimated Quantitatively Measurable Misstatements		**$0**	**$0**
Materiality Benchmark ($ amount and benchmark used)		**[Add $ amount of benchmark used here]**	**[Describe benchmark used (total assets, total cost, etc.)]**
Total Estimated Quantitatively Measurable Misstatements as a Percentage of Materiality Benchmark		**0.0%**	**0.0%**
[Add auditor's note regarding the auditor's assessment of the percentage.]			

STATEMENT OF BUDGETARY RESOURCES – STATUS OF BUDGETARY RESOURCES			
A	**B**	**C**	**D**
		Estimated Amounts	
Audit Exposure (Quantitative)	**Doc. Ref.**	Absolute Value Effect of Factors Not Directly Affecting the Materiality Benchmark	Net Effect of Factors Directly Affecting the Materiality Benchmark, on the Materiality Benchmark
Factual Uncorrected Misstatements:[1]		$0	$0
Judgmental Uncorrected Misstatements:		0	0
Subtotal: Factual and Judgmental Uncorrected Misstatements		**$0**	**$0**
Estimate of Potential Undetected Misstatements:			
Untested Amounts		0	0
Combined Sampling Precision; Non-MUS Sample(s)		0	0
Combined Sampling Precision; MUS Sample(s)		0	0
[Include Performance Materiality amount if no statistical sampling was performed (and therefore no global upper error limit amount was included in the two rows above)]		0	0
Allowance for Imprecision of Analytical Procedures on which Complete Substantive Reliance Was Placed		0	0
Other[2]		0	0
Subtotal: Estimated Quantitatively Measurable Undetected Misstatements		**$0**	**$0**
Total Estimated Quantitatively Measurable Misstatements		**$0**	**$0**
Materiality Benchmark ($ amount and benchmark used)		**[Add $ amount of benchmark used here]**	**[Describe benchmark used (total assets, total cost, etc.)]**
Total Estimated Quantitatively Measurable Misstatements as a Percentage of Materiality Benchmark		**0.0%**	**0.0%**
[Add auditor's note regarding the auditor's assessment of the percentage.]			

STATEMENT OF BUDGETARY RESOURCES – OUTLAYS, NET AND DISBURSEMENTS, NET			
A	**B**	**C**	**D**
		Estimated Amounts	
Audit Exposure (Quantitative)	**Doc. Ref.**	Absolute Value Effect of Factors Not Directly Affecting the Materiality Benchmark	Net Effect of Factors Directly Affecting the Materiality Benchmark, on the Materiality Benchmark
Factual Uncorrected Misstatements:[1]		$0	$0
Judgmental Uncorrected Misstatements:		0	0
Subtotal: Factual and Judgmental Uncorrected Misstatements		**$0**	**$0**
Estimate of Potential Undetected Misstatements:			
Untested Amounts		0	0
Combined Sampling Precision; Non-MUS Sample(s)		0	0
Combined Sampling Precision; MUS Sample(s)		0	0
[Include Performance Materiality amount if no statistical sampling was performed (and therefore no global upper error limit amount was included in the two rows above)]		0	0
Allowance for Imprecision of Analytical Procedures on Which Complete Substantive Reliance Was Placed		0	0
Other[2]		0	0
Subtotal: Estimated Quantitatively Measurable Undetected Misstatements		**$0**	**$0**
Total Estimated Quantitatively Measurable Misstatements		**$0**	**$0**
Materiality Benchmark ($ amount and benchmark used)		**[Add $ amount of benchmark used here]**	**[Describe benchmark used (total assets, total cost, etc.)]**
Total Estimated Quantitatively Measurable Misstatements as a Percentage of Materiality Benchmark		**0.0%**	**0.0%**
[Add auditor's note regarding the auditor's assessment of the percentage.]			

STATEMENT OF {NAME OF STATEMENT}			
A	**B**	**C**	**D**
		Estimated Amounts	
Audit Exposure (Quantitative)	**Doc. Ref.**	Absolute Value Effect of Factors Not Directly Affecting the Materiality Benchmark	Net Effect of Factors Directly Affecting the Materiality Benchmark, on the Materiality Benchmark
Factual Uncorrected Misstatements:[1]		$0	$0
Judgmental Uncorrected Misstatements:		0	0
Subtotal: Factual and Judgmental Uncorrected Misstatements		**$0**	**$0**
Estimate of Potential Undetected Misstatements:			
Untested Amounts		0	0
Combined Sampling Precision; Non-MUS Sample(s)		0	0
Combined Sampling Precision; MUS Sample(s)		0	0
[Include Performance Materiality amount if no statistical sampling was performed (and therefore no global upper error limit amount was included in the two rows above)]		0	0
Allowance for Imprecision of Analytical Procedures on Which Complete Substantive Reliance Was Placed		0	0
Other[2]		0	0
Subtotal: Estimated Quantitatively Measurable Undetected Misstatements		**$0**	**$0**
Total Estimated Quantitatively Measurable Misstatements		**$0**	**$0**
Materiality Benchmark ($ amount and benchmark used)		**[Add $ amount of benchmark used here]**	**[Describe benchmark used (total assets, total cost, etc.)]**
Total Estimated Quantitatively Measurable Misstatements as a Percentage of Materiality Benchmark		**0.0%**	**0.0%**
[Add auditor's note regarding the auditor's assessment of the percentage.]			

Explanatory Comments[2]

[1]Include only the identified factual misstatements due to errors arising from nonstatistical selections or other nonstatistical tests. The full estimated effect of the outcome of statistical tests (projected misstatement) will be included in the combined sampling precision calculations, including the related factual amount.

[2]Describe in "Explanatory Comments" section any factor that does not fall into one of the listed categories.

Section III: Consideration of Notes to the Financial Statements

Note No.	Note Name	Description of Misstatement or Potential Undetected Misstatement	Auditor's Assessment	Doc. Ref.
	[Identify any notes to the financial statements containing misstatements or for which there is a risk of significant potential undetected misstatements (other than those that are clearly trivial) to the extent the misstatement is not fully considered in section II.]	[Describe the misstatement or potential undetected misstatement. Include a reference to any related misstatement in section II.]	[Assess the significance of the misstatement or potential undetected misstatement, including quantitative and qualitative factors considered.]	

Section IV: Consideration of Other Factors

	Description	Explanatory Comments	Doc. Ref.
1	Imprecision of analytical procedures on which only partial reliance was placed		
2	Audit exposure affecting amounts on the financial statements that do not affect the materiality benchmark (section II, column C), when considered in relation to the total of the amounts they directly affect[1]		
3	Consideration of all corrected misstatements identified		
4	*{insert other factors—consider factors noted in FAM 540.23}*		

[1]For example, if the materiality benchmark is total assets, exposure affecting liability amounts on the balance sheet would not directly affect the benchmark and would therefore be entered to column C in section II. As a qualitative factor, the auditor should assess whether the quantifiably measurable exposure affecting liability amounts, when considered in relation to total liabilities, was relevant and potentially significant.

550 – Perform Other Reporting Phase Audit Procedures

.01 The auditor should

- perform procedures regarding litigation, claims, and assessments involving the entity that may give rise to a risk of material misstatement (see FAM 550.02–.03);
- identify material subsequent events and subsequently discovered facts (see FAM 550.04–.08);
- obtain management representations (see FAM 550.09–.16);
- assess relationships and transactions with disclosure entities, related parties, and public-private partnerships (see FAM 550.17);
- communicate with those charged with governance (see FAM 550.18–.22);
- assess RSI and other information (see FAM 550.23–.29); and
- consider the entity's ability to continue as a going concern (see FAM 550.31–.32).

Litigation, Claims, and Assessments

.02 As discussed in FAM 280.02 through .05, the auditor should make inquiries of the entity's legal counsel and perform other procedures regarding litigation, claims, and assessments involving the entity that may give rise to a risk of material misstatement. In considering any liabilities, contingencies, or uncertainties that may affect the entity or its financial statements, the auditor should seek direct communication with the entity's in-house and, if appropriate, external legal counsel regarding these matters. The auditor should do so through a legal counsel request prepared by management and sent by the auditor requesting the entity's legal counsel to communicate directly with the auditor.

.03 Further guidance on audit procedures related to litigation, claims, and assessments, including the evaluation of legal counsel responses, is provided in AU-C 501, *Audit Evidence—Specific Considerations for Selected Items*; Office of Management and Budget (OMB) audit guidance; FAM 280; and FAM 1002.

Identify Material Subsequent Events and Subsequently Discovered Facts

.04 Subsequent events are events occurring between the date of the financial statements and the date of the auditor's report. The auditor should perform audit procedures to obtain sufficient appropriate audit evidence that all subsequent events that require adjustments of, or disclosure in, the financial statements have been identified (AU-C 560.09). The auditor should perform procedures required by AU-C 560.10, which are included in FAM 1005. See AU-C 560, *Subsequent Events and Subsequently Discovered Facts*, and FAM 1005 for additional guidance. If, as a result of these performed procedures, the auditor identifies subsequent events that require adjustment of, or disclosure in, the financial statements, the auditor should determine whether each such event is appropriately reflected in the financial statements in accordance with U.S. GAAP (AU-C 560.11).

.05 The auditor should perform subsequent event procedures near the completion of the audit and should include any events between the date of the financial statements and the date of the auditor's report. If a long period elapses from the date of the auditor's report to report release date, the auditor should update the procedures through the report release date.

The auditor should follow AU-C 560.13 and AU-C 700, *Forming an Opinion and Reporting on Financial Statements*, on dating the auditor's report if management appropriately revises the financial statements for subsequent events and should obtain updated or additional representations from management, as appropriate. If management does not revise the financial statements in circumstances when the auditor believes they need to be revised, the auditor should modify the opinion (express a qualified or an adverse opinion), as required by AU-C 705, *Modifications to the Opinion in the Independent Auditor's Report* (AU-C 560.14). See FAM 580 for guidance on drafting the auditor's report.

.06 The auditor is not required to perform any procedures regarding the financial statements after the date of the auditor's report (AU-C 560.12). The auditor may inquire of management to determine if it is aware of subsequently discovered facts (defined as facts that become known to the auditor after the date of the auditor's report that, had they been known to the auditor at that date, may have caused the auditor to revise the auditor's report—see AU-C 560.07) that could materially affect the financial statements (see FAM 1005.05). If the auditor becomes aware of a subsequently discovered fact before the report release date, the auditor should

- discuss the matter with management and, when appropriate, those charged with governance and
- determine whether financial statements need revision and, if so, inquire how management intends to address the matter in the financial statements (see AU-C 560.12).

If a subsequently discovered fact becomes known to the auditor after the report release date, the auditor should follow AU-C 560.15 through .18.

.07 The auditor should inquire of management and, when appropriate, those charged with governance about whether there were any changes in internal control over financial reporting or conditions that might significantly affect internal control over financial reporting subsequent to the as of date but before the date of the auditor's report (AU-C 940.48), and perform the procedures in AU-C 940.48, which are also included in FAM 1005.

If the auditor becomes aware of any such changes in internal control, the auditor should determine whether the changes significantly affect the effectiveness of the entity's internal control and their impact on the auditor's report, as discussed in FAM 580.

.08 The auditor has no responsibility to keep informed of events subsequent to the date of the report on internal control; however, after the release of the report on internal control, the auditor may become aware of conditions that existed at the report date that might have affected the auditor's opinion had the auditor been aware of them. The evaluation of such subsequent information is similar to the evaluation of facts discovered subsequent to the date of the report on an audit of financial statements, as discussed above.

Obtain Management Representations

.09 As discussed in FAM 280.06, the auditor should request written representations from management with appropriate responsibilities for the financial statements and knowledge of the matters concerned (AU-C 580.09) (this may include those charged with governance when appropriate). These representations should be in the form of a representation letter addressed to the auditor (AU-C 580.21). These representations supplement the other audit procedures performed by the auditor but are not a substitute for them. Written representations help avoid any misunderstandings that could arise if only oral representations were received from management. In some circumstances, corroborating evidence for representations may not be readily available, such as for those involving management's intent concerning a future transaction or business decision.

.10 The auditor should request that management provide the representations described in FAM 1001.09 through .28, as applicable, including that management has fulfilled its responsibilities as set out in the terms of the engagement. See FAM 1001 for additional guidance on obtaining management representations and FAM 1001 A for an example representation letter.

.11 If the auditor has concerns about the competence, integrity, ethical values, or diligence of management or about management's commitment to, or enforcement of, these, the auditor should determine the effect that such concerns may have on the reliability of representations (oral and written) and audit evidence in general (AU-C 580.22). In particular, if written representations are inconsistent with other audit evidence, the auditor should perform audit procedures to attempt to resolve the matter. If the matter remains unresolved, the auditor should reconsider the assessment of the competence, integrity, ethical values, or diligence of management or of management's commitment to, or enforcement of, these and should determine the effect that this may have on the reliability of representations (oral or written) and audit evidence in general (AU-C 580.23).

In the case of identified inconsistencies between one or more written representations and audit evidence obtained from another source, the auditor may consider whether the risk assessment remains appropriate and, if not, may revise the risk assessment and determine the nature, timing, and extent of further audit procedures to respond to the risks of material misstatement (AU-C 580.A30).

If the auditor concludes that the written representations are not reliable, the auditor should take appropriate action, including determining the possible effect on the opinion in the auditor's report in accordance with FAM 580.43, considering the requirement discussed in FAM 550.12 (AU-C 580.24). The auditor must provide the auditor's conclusion to the reviewer in a timely manner to allow any issues to be promptly identified and resolved.

.12 Based on AU-C 580.25, the auditor should disclaim an opinion on the financial statements if

- the auditor concludes that sufficient doubt exists about the integrity of management such that the written representations described in FAM 1001.09a, .10, and .11a are not reliable or
- management does not provide those representations.

.13 If management does not provide one or more of the requested written representations as described in FAM 1001.09 through .28, the auditor should

- discuss the matter with management;
- reevaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and
- take appropriate actions, including determining the possible effect on the opinion in the auditor's report, considering the requirement discussed in FAM 550.12 (AU-C 580.26).

Management's refusal to furnish written representations constitutes a limitation on the scope of the audit. Such refusal is often sufficient to preclude an unmodified opinion (AU-C 580.A33).

.14 In an audit of internal control over financial reporting performed as part of an integrated audit, the failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the audit. The auditor should evaluate the effects of management's refusal on the auditor's ability to rely on other representations, such as those obtained during the audit of the entity's financial statements. See AU-C 940.73 through .77 for additional guidance and determine the effect on the auditor's report, as discussed in FAM 580.

.15 The auditor should request that members of management and, when appropriate, those charged with governance, who are responsible for and knowledgeable about, directly or through others in the organization, the matters covered by the representations, including the preparation and fair presentation of the financial statements and the completeness of the information provided to the auditor, sign the letter (AU-C 580.06a, .09, and .A2). As discussed in OMB audit guidance, the signers generally should be officials at the highest levels of the audited entity responsible for overseeing the financial reporting process and generally should be the head of the entity, the chief financial officer (CFO), and any others deemed responsible for matters presented in this letter.

.16 Management should date the representation letter as of the date of the auditor's report. Typically, senior management will review the final financial statements and note disclosures to take responsibility for them before signing the representation letter. Although the auditor is not required to perform audit procedures regarding the financial statements after the date of the auditor's report, the auditor may determine that an updated management representation letter is necessary to provide evidence concerning events subsequent to the report date. For example, the auditor may determine that updated management representations are needed to

- support a determination that subsequent events identified after the report date do not require revisions to the financial statements;
- support a revised report date because of revisions to the financial statements as a result of a subsequent event; or
- provide evidence that no subsequent events have occurred, particularly where the financial statements are not issued shortly after the audit report release date.

Assess Relationships and Transactions with Disclosure Entities, Related Parties, and Public-Private Partnerships

.17 The auditor should evaluate whether the identified relationships and transactions with disclosure entities, related parties, and public-private partnerships have been appropriately accounted for and disclosed.[6] The auditor should also evaluate whether the effects of such relationships and transactions prevent the financial statements from achieving fair presentation (AU-C 550.28). See FAM 280.07, FAM 904, and AU-C 550, *Related Parties*, for additional guidance on relationships and transactions with disclosure entities, related parties, and public-private partnerships. Statement of Federal Financial Accounting Standards (SFFAS) 47 provides the definitions of related parties and disclosure entities and related disclosure requirements for federal entities. SFFAS 49 provides the criteria for public-private partnerships and related disclosure requirements for federal entities.

Communicate with Those Charged with Governance

.18 The auditor should communicate with those charged with governance findings and issues from the audit that are, in the auditor's professional judgment, significant and relevant to their responsibility to oversee the financial reporting process. Those charged with governance are those responsible for overseeing the strategic direction of the entity and obligations related to the accountability of the entity, including overseeing the entity's financial reporting process. At the start of the audit, as part of gaining an understanding of the entity, the auditor should have identified those charged with governance for the entity (see FAM 215). As discussed in FAM 215, in some instances, those charged with governance may include management. The auditor should communicate the following with those charged with governance:

a. The auditor's views about **qualitative aspects of significant accounting practices**, including accounting policies, accounting estimates, and note disclosures. When applicable, the auditor should take the following actions:

- Explain to those charged with governance why the auditor considers a significant accounting practice that is acceptable under the applicable financial reporting framework (generally U.S. GAAP) not to be the most appropriate to the particular circumstances (AU-C 260.12a.i).
- Determine that those charged with governance are informed about the process management uses in formulating particularly sensitive accounting estimates, including fair value estimates, and about the basis for the auditor's conclusion regarding the reasonableness of those estimates

[6]Under Federal Accounting Standards Advisory Board (FASAB) standards, organizations are considered to be related parties if the existing relationship or one party to the existing relationship has the ability to exercise significant influence over the other party's policy decisions. In the federal government, there are additional relationships that present risks similar to related parties, as defined by FASAB. These include disclosure entities and public-private partnerships. Consequently, while AU-C 550, *Related Parties*, addresses only related parties, the auditor should apply audit procedures required for related parties in AU-C 550 to disclosure entities and public-private partnerships. Note that FASAB and the Financial Accounting Standards Board (FASB) provide different definitions for related parties. Procedures pertaining to disclosure entities and public-private partnerships do not apply to entities issuing financial statements in accordance with FASB accounting standards.

(AU-C 260.12a.ii). In doing so, the auditor should consider which matters, if any, to communicate regarding accounting estimates, taking into account whether the risks of material misstatement relate to estimation uncertainty or the effects of complexity, subjectivity, or other inherent risk factors in making accounting estimates and related note disclosures (AU-C 540.37). See FAM 905 for further guidance on accounting estimates.

See AU-C 260.A27 through .A29 for items the auditor may consider communicating related to accounting practices.

b. **Significant unusual transactions**, if any (AU-C 260.12b and .A30). See FAM 265.54c for a discussion of significant unusual transactions.

c. **Significant difficulties**, if any, that the auditor encountered during the audit (AU-C 260.12c). See AU-C 260.A31 and AU-C 730.06 for examples of difficulties, such as significant delays in receiving required information, extensive unexpected effort necessary to obtain sufficient appropriate audit evidence, an unreasonably brief time within which to complete the audit, and inability to complete procedures related to RSI.

d. **Uncorrected misstatements**, other than those the auditor believes are clearly trivial, including the following (AU-C 260.13):

- The effect that the uncorrected misstatements, individually or in the aggregate, may have on the opinion in the auditor's report. The auditor's communication should identify material uncorrected misstatements individually (see FAM 595 C, example 1). The auditor should request that uncorrected misstatements be corrected (AU-C 260.13a). When there are a large number of individually immaterial uncorrected misstatements, the auditor may communicate the number and overall monetary effect of the uncorrected misstatements, rather than the details of each uncorrected misstatement (AU-C 260.A38). The auditor may discuss the reasons for, and the implications of, failing to correct misstatements, taking into account the size and nature of the misstatement judged in the surrounding circumstances and possible implications with regard to future financial statements (AU-C 260.A39).

- The effect of uncorrected misstatements related to prior periods on line items, accounts, note disclosures, or classes of transactions and on the financial statements as a whole (AU-C 260.13b).

- That uncorrected misstatements or matters underlying those uncorrected misstatements could potentially cause future-period financial statements to be materially misstated, even if the auditor has concluded that the uncorrected misstatements are immaterial to the financial statements under audit (AU-C 260.13c).

e. Any **disagreements with management**, regardless of whether they were satisfactorily resolved, about matters that individually or in the aggregate could be significant to the entity's financial statements or the auditor's report (AU-C 260.12d). Examples of disagreements are included in AU-C 260.A32. For this purpose, disagreements do not include differences of opinion based on incomplete facts or preliminary information that are later resolved.

f. **Circumstances that affect the form and content of the auditor's report**, if any, such as the auditor's planned modifications to the audit opinion or

inclusion of emphasis-of-matter or other-matter paragraphs in the auditor's report (AU-C 260.12e and .A34). The auditor should also communicate to those charged with governance the wording of the expected modification to the auditor's report (AU-C 705.31 and 706.12).

g. **Matters that are difficult or contentious** for which the auditor consulted outside the engagement team and that are, in the auditor's professional judgment, significant and relevant to those charged with governance regarding their responsibility to oversee the financial reporting process (AU-C 260.12f).

h. **Other findings or issues**, if any, arising during the audit that are, in the auditor's professional judgment, significant and relevant to those charged with governance regarding their responsibility to oversee the financial reporting process (AU-C 260.12g).

i. Unless all of those charged with governance are involved in managing the entity, the auditor also should communicate the following:

- **Material corrected misstatements** that were brought to the attention of management as a result of audit procedures (see FAM 595 C, example 2) (AU-C 260.14a).
- **Management representations** requested by the auditor (AU-C 260.14d). The auditor may provide those charged with governance a copy of management's written representations (AU-C 260.A42).
- The auditor's views about significant matters that were the subject of **management's consultations with other accountants**, if any, on accounting and auditing matters when the auditor is aware that such consultation has occurred (AU-C 260.14c).
- Any **significant findings or issues** arising during the audit that were discussed with management or that were the subject of correspondence with management (AU-C 260.14b). AU-C 260.A41 includes examples of significant matters that the auditor may communicate.
- Significant findings or issues in connection with the entity's relationships and transactions with **disclosure entities, related parties, and public-private partnerships** (AU-C 550.29).

j. **Identified or suspected fraud** involving (1) management, (2) employees who have significant roles in internal control, or (3) others when the fraud results in a material misstatement in the financial statements. If the auditor suspects fraud involving management, the auditor should discuss the nature, timing, and extent of audit procedures necessary to complete the audit. Also, the auditor should discuss any other matters involving fraud that are, in the auditor's professional judgment, relevant to those charged with governance's responsibility (AU-C 240.40–.41).

k. **Suspected noncompliance** with laws, regulations, contracts, or grant agreements when the auditor determines that it is appropriate to discuss with those charged with governance (AU-C 250.18).

l. The auditor's responsibility and procedures performed relating to **other information** included in the annual report and the results of these procedures (AU-C 720.15).

m. Matters involving **identified or suspected noncompliance** with laws, regulations, contracts, or grant agreements that come to the auditor's attention during the audit, unless clearly inconsequential. If, in the auditor's professional judgment, the matter is believed to be intentional and material, the auditor should communicate the matter as soon as practicable (AU-C 250.21–.22).

n. **Significant deficiencies and material weaknesses** identified during the audit, including those that were remediated during the audit (AU-C 265.11). For an integrated audit, the auditor should communicate in writing to management and those charged with governance significant deficiencies and material weaknesses identified during the integrated audit, including those that were remediated during the integrated audit and those that were previously communicated but have not yet been remediated (AU-C 940.59).

o. If management has imposed a **limitation on the scope of the audit** and refuses to remove the limitation, the auditor should communicate the matter to those charged with governance, unless all of those charged with governance are involved in managing the entity, and if appropriate, determine whether it is possible to perform alternative procedures to obtain sufficient appropriate audit evidence (AU-C 705.11 and .12).

p. A material misstatement of the financial statements that relates to the **omission of information** required to be presented or disclosed (AU-C 705.24a).

AU-C 260.A25 through .A42 provide further guidance on these matters. Matters that arose during the audit that were communicated to those charged with governance and satisfactorily resolved do not need to be included in the communication.

.19 As discussed in FAM 215.33, the auditor should communicate significant findings and issues in writing to those charged with governance if, in the auditor's professional judgment, oral communication would not be adequate. This communication need not include matters that arose during the course of the audit that were communicated with those charged with governance and satisfactorily resolved. Factors that may affect whether to communicate orally or in writing, the extent of detail or summarization in the communication, and the formality of the communication are discussed in AU-C 260.A48 through .A50. Effective communication may involve formal presentations and written reports as well as less formal communications, including discussions (AU-C 260.A48–.A50).

As discussed in FAM 215.37 and .38, the auditor should communicate with those charged with governance on a timely basis and should document all matters that are required to be communicated, including when and to whom they were communicated.

.20 If, as part of its communication to those charged with governance, management communicated some or all of the matters the auditor is required to communicate, and as a result, the auditor did not communicate these matters at the same level of detail as management, the auditor should communicate any omitted or inadequately described matters to those charged with governance. The auditor does not need to communicate them at the same level of detail as to management, as long as the auditor (a) participated in management's discussion with those charged with governance and (b) affirmatively confirmed to those

charged with governance that management has adequately communicated these matters (AU-C 260.17).

.21 The auditor should evaluate the adequacy of the two-way communication between the auditor and those charged with governance for the purposes of the audit (AU-C 260.20). Inadequate two-way communication may indicate an unsatisfactory control environment, which will influence the auditor's assessment of the risks of material misstatements. There is also a risk that the auditor may not have obtained sufficient appropriate audit evidence to form an opinion on the financial statements (AU-C 260.A54). The auditor does not need to design specific procedures to evaluate the adequacy of this communication. Rather, the auditor may base the evaluation on observations resulting from audit procedures performed for other purposes. Such observations may include the following (AU-C 260.A53):

- the appropriateness and timeliness of actions taken by those charged with governance in response to matters the auditor communicated;
- the apparent openness of those charged with governance in their communications with the auditor;
- the willingness and capacity of those charged with governance to meet with the auditor without management present;
- the apparent ability of those charged with governance to fully comprehend matters communicated by the auditor, such as the extent to which those charged with governance probe issues and question recommendations made to them;
- difficulty in establishing with those charged with governance a mutual understanding of the form, timing, and expected general content of communications; and
- when all or some of those charged with governance are involved in managing the entity, their apparent awareness of how matters discussed with the auditor affect their broader governance responsibilities, as well as their management responsibilities.

.22 If the two-way communication between the auditor and those charged with governance is not adequate, the auditor should evaluate the effect, if any, on the auditor's assessment of the risks of material misstatement and ability to obtain sufficient appropriate audit evidence and should take appropriate action. If the situation cannot be resolved, the auditor may take actions as discussed in AU-C 260.A55, including modifying the auditor's opinion for a limitation on the scope of the audit (AU-C 260.20 and .A55).

Assess RSI and Other Information

.23 The auditor should conclude on procedures performed for RSI and other information. See FAM 580.38 through .39 regarding how the auditor reports on the work performed in these areas.

.24 For RSI, the auditor should determine whether there are any omissions, material departures from Federal Accounting Standards Advisory Board (FASAB) guidance, or material inconsistencies with the financial statements and the auditor's knowledge, based on procedures performed in FAM 280.08. The

auditor should also obtain management representations regarding RSI as specified in FAM 280.08. If the auditor is unable to complete the procedures described in FAM 280.08, the auditor should consider whether management contributed to the auditor's inability to complete the procedures. If the auditor concludes that the inability to complete the procedures was due to significant difficulties encountered in dealing with management, the auditor should inform those charged with governance (AU-C 730.06).

.25 For other information, the auditor should determine whether there are any material inconsistencies with the audited financial statements or misstatement of fact based on procedures performed in FAM 280.09.

.26 If the auditor identifies that a material inconsistency appears to exist between the other information and the audited financial statements or becomes aware that the other information appears to be materially misstated, the auditor should discuss the matter with management and, if necessary, perform other procedures to conclude whether (1) a material misstatement of the other information exists, (2) a material misstatement of the financial statement exists, and (3) the auditor's understanding of the entity and its environment needs to be updated (AU-C 720.19).

.27 If the auditor concludes that a material misstatement of the other information exists, the auditor should request that management correct the other information and, if management agrees to make the correction, determine that the correction has been made. If management refuses to make the correction, the auditor should communicate the matter to those charged with governance and request that the correction be made. If the other information is not corrected after communicating with those charged with governance, the auditor should consider the implications for the auditor's report and communicate to those charged with governance about how the auditor plans to address the material misstatement in the auditor's report (AU-C 720.20 and .21a). If the auditor concludes that a material misstatement exists in other information obtained after the date of the auditor's report, the auditor should follow the requirements in AU-C 720.22.

.28 If, as a result of performing procedures on other information, the auditor concludes that a material misstatement in the financial statements exists or the auditor's understanding of the entity and its environment needs to be updated, the auditor should respond appropriately in accordance with other relevant AU-C sections (AU-C 720.23).

.29 In reading the other information, the auditor may become aware of new information that has implications for the following (AU-C 720.A55):

- the auditor's understanding of the entity and its environment, the financial reporting framework (generally U.S. GAAP), and the entity's internal control, which may indicate the need to revise the auditor's risk assessment;
- the auditor's responsibility to evaluate the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements; and
- the auditor's responsibilities related to subsequent events.

Supplementary Information

.30 If the auditor is engaged to report on whether supplementary information, such as consolidating statements, is fairly stated, in all material respects, in relation to the financial statements as a whole, the auditor should follow the requirements in AU-C 725.

Consider the Entity's Ability to Continue as a Going Concern

.31 AU-C 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, discusses the implications for the auditor's report if conditions and events have been identified that raise substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time. However, according to SFFAS 39, *Subsequent Events: Codification of Accounting and Financial Reporting Standards Contained in the AICPA Statements on Auditing Standards*, appendix A, FASAB considered the nature of the federal government and determined that "going concern" as contemplated in the commercial sense is not applicable to federal government financial reporting.

.32 For entities that conform to Financial Accounting Standards Board (FASB) standards, the auditor should evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time based on the results of the audit procedures performed pursuant to AU-C 570.

560 – Determine Whether Financial Statement Presentation Is in Accordance with U.S. Generally Accepted Accounting Principles

.01 U.S. GAAP for federal government entities is promulgated by FASAB. As permitted by SFFAS 34, *The Hierarchy of Generally Accepted Accounting Principles, Including the Application of Standards Issued by the Financial Accounting Standards Board*, some federal entities, including government corporations, prepare financial statements in accordance with standards promulgated by FASB. For further information on the requirements for applying FASB standards, see SFFAS 34.

.02 FASAB established the hierarchy of accounting principles for federal entities in SFFAS 34. This hierarchy is presented below, from most authoritative to least authoritative.

a. FASAB Statements and Interpretations and AICPA and FASB pronouncements made applicable to federal governmental entities by a FASAB Statement or Interpretation.

b. FASAB Technical Bulletins and the following pronouncements if the AICPA specifically made them applicable to federal governmental entities and FASAB cleared them: AICPA Industry Audit and Accounting Guides and AICPA Statements of Position.

c. AICPA Accounting Standards Executive Committee Practice Bulletins if specifically made applicable to federal governmental entities and cleared by FASAB and Technical Releases of its Accounting and Auditing Policy Committee.

d. Implementation guides published by FASAB staff and practices that are widely recognized and prevalent in the U.S. government.

.03 In the absence of a pronouncement in the above hierarchy, the auditor may evaluate other accounting literature, including

a. FASAB Concepts Statements;

b. pronouncements in categories a through d in FAM 560.02 when not specifically made applicable to federal governmental entities;

c. FASB and Government Accounting Standards Board (GASB) Concepts Statements;[7]

d. GASB Statements, Interpretations, and Technical Bulletins;

e. AICPA Issue Papers;

f. International Accounting Standards of the International Accounting Standards Committee;

g. pronouncements of other professional associations or regulatory agencies;

[7]GASB establishes U.S. GAAP for units of state and local governments.

h. AICPA Technical Practice Aids; and

i. accounting textbooks, handbooks, and articles.

.04 Entities summarize their significant accounting policies, usually in note 1 to the financial statements.

.05 The auditor should perform audit procedures to evaluate whether the financial statements are prepared and presented, in all material respects, in accordance with U.S. GAAP or other applicable financial reporting framework (AU-C 330.26 and 700.14). See FAM 215.14 for discussion of financial reporting framework. This evaluation should include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments (AU-C 700.14). This evaluation should include the following:

a. Whether, in view of the requirements of the applicable financial reporting framework (generally U.S. GAAP):

- The financial statements appropriately disclose the significant accounting policies selected and applied. In making this evaluation, the auditor should consider the relevance of the accounting policies to the entity and whether they have been presented in an understandable manner.
- The accounting policies selected and applied are consistent with the applicable financial reporting framework (generally U.S. GAAP) and are appropriate.
- The accounting estimates and related note disclosures made by management are reasonable.
- The information presented in the financial statements is relevant, reliable, comparable, and understandable. In making this evaluation, the auditor should consider whether all required information has been included, and whether such information is appropriately described, classified, aggregated or disaggregated, and presented.
- The financial statements provide adequate note disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements.
- The terminology used in the financial statements, including the title of each financial statement, is appropriate (AU-C 700.15).

b. Whether the financial statements achieve fair presentation, including consideration of the following:

- the appropriate classification and description of financial information and the underlying transactions, events, and conditions;
- the appropriate presentation, structure, and content of the financial statements (AU-C 330.26); and
- whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation (AU-C 700.16).

c. Whether the financial statements adequately refer to or describe the applicable financial reporting framework (generally U.S. GAAP) (AU-C 700.17).

The auditor can meet the requirement for the above evaluations by completing the Federal Financial Reporting Checklist.[8] This checklist also can assist the entity in preparing financial statements with appropriate and adequate note disclosures in accordance with U.S. GAAP.

.06 For accounting estimates, the auditor's procedures should address whether management has developed note disclosures about estimation uncertainty related to management's point estimate (AU-C 540.25b).[9] The greater the degree to which an accounting estimate is subject to estimation uncertainty, the more likely the risks of material misstatement will be assessed as higher and, therefore, the more persuasive the audit evidence needs to be to determine whether management's point estimate and related note disclosures about estimation uncertainty are reasonable in the context of the applicable financial reporting framework (generally U.S. GAAP) or are misstated (AU-C 540.A113). See FAM 905 for further guidance on auditing accounting estimates.

.07 The auditor should evaluate the impact of any instances where the financial statements are not in accordance with U.S. GAAP and should determine the effects, if any, on the auditor's report (see FAM 580.09–.10).

[8]The Federal Financial Reporting Checklist is contained in FAM volume 3, which is available at https://www.gao.gov/financial_audit_manual (accessed June 6, 2024).

[9]See AU-C 540.A46, .A47, and .A49 for discussion of instances where U.S. GAAP specifies an approach to selecting management's point estimate from a range of reasonably possible outcomes (e.g., a contingent liability) and instances where U.S. GAAP may require disclosure of a range of possible outcomes.

570 – Determine Compliance with GAO/CIGIE *Financial Audit Manual*

.01 The auditor should determine whether the audit was conducted in accordance with GAGAS and, if applicable, OMB audit guidance. The auditor should also determine whether the FAM methodology was followed. One tool the auditor should use to determine and document FAM compliance and whether there are any exceptions or deviations is the audit completion checklist in FAM 1003. If the auditor is using a different methodology and if required by contract, the auditor should use the audit completion checklist to provide a crosswalk between the audit methodology used and the FAM.

580 – Draft Reports

.01 Based on AU-C 700.21, at the conclusion of the audit, the auditor should draft written reports on the entity's

- financial statements, RSI (including MD&A), and other information included in the annual report (see FAM 580.02–.55);
- internal control over financial reporting (see FAM 580.56–.85);
- financial management systems' substantial compliance with the three FFMIA requirements (for CFO Act agencies) (see FAM 580.86–.90);[10] and
- compliance with significant provisions of applicable laws, regulations, contracts, and grant agreements (see FAM 580.91–.99).

If the auditor is engaged to report on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole, the auditor should follow the reporting requirements in AU-C 725.

Financial Statement Reporting

.02 The auditor should form an opinion on whether the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework (generally U.S. GAAP) (AU-C 700.12).

Audit Scope

.03 To express an opinion, first the auditor should determine if the audit has been conducted in accordance with GAGAS and, if applicable, OMB audit guidance (see FAM 570). The auditor should conclude whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error (AU-C 700.13). If the auditor is not able to perform all procedures considered necessary, the scope of the audit is restricted, and the auditor should consider whether to modify the GAGAS compliance statement in the report, as discussed in GAGAS (2018) 2.17b, 2.18 and 2.20, and determine whether to qualify or disclaim an opinion.

.04 Limitations on the scope of the auditor's work resulting in the auditor's inability to obtain sufficient appropriate audit evidence may be imposed by the entity, may be caused by circumstances beyond the entity's control, or may result from circumstances related to the nature or the timing of the audit work. Examples of scope limitations are included in AU-C 705.A9 through .A13. Limitations imposed by the entity may have other implications for the audit, such as the auditor's assessment of risk of material misstatement due to fraud.

.05 Based on AU-C 330.28, the auditor should conclude whether sufficient appropriate audit evidence has been obtained to reduce the risk of undetected material misstatements to an appropriately low level in the financial statements. The auditor's conclusion on whether sufficient appropriate audit evidence has been obtained is both at the assertion level as well as the financial statement level (AU-C 330.A79). In forming a conclusion, the auditor should consider all

[10]Non-GAO auditors may combine bullets 3 and 4.

relevant audit evidence, regardless of whether it appears to corroborate or contradict the assertions in the financial statements. AU-C 330.A79 presents factors that may influence this conclusion on the sufficiency and appropriateness of audit evidence.

.06 The auditor should determine whether any misstatements affect the audit scope from a qualitative standpoint. The auditor should also determine whether the audit scope is adequate in light of any (1) misstatements or (2) other findings that indicate noncompliance with significant provisions of applicable laws, regulations, contracts, and grant agreements.

.07 Based on AU-C 330.29, if the auditor has not obtained sufficient appropriate audit evidence related to a significant assertion about a material line item, account, note disclosure, or class of transactions, the auditor should attempt to obtain further audit evidence. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor should determine the implications on the audit opinion following guidance in FAM 580.43 and include the reasons for that inability in the "Basis for Opinion" section (AU-C 705.13 and .25).

.08 Whether to qualify or disclaim an opinion because of a scope limitation is a matter of the auditor's professional judgment. The auditor should assess how important the omitted procedures were to the auditor's ability to form an opinion on the financial statements based on sufficient appropriate audit evidence. This assessment is influenced by the nature, significance, and magnitude of the items to which the omitted procedures relate. For example, the potential effect of a scope limitation on a material account is likely to be greater than on an immaterial account.

Departure from U.S. GAAP (Misstatements)

.09 The auditor should evaluate whether the financial statements as a whole, including the related note disclosures, are materially misstated based on a departure from U.S. GAAP, as discussed in FAM 560. If such a departure exists, the auditor should determine the effects of the departure on the financial statements, considering both quantitative and qualitative aspects. The auditor should conclude whether the effects of the misstatements, individually or in the aggregate, are (1) material and (2) pervasive to the financial statements. See FAM 580.43 for further discussion.

.10 In rare cases when the auditor can demonstrate that compliance with U.S. GAAP would result in misleading financial statements, the auditor may issue an unmodified opinion that includes a description of the nature of the departure; the effects, if practicable; and why compliance with U.S. GAAP would result in misleading financial statements (see the *AICPA Code of Professional Conduct*, 1.320.001 Accounting Principles Rule). The auditor's conclusion regarding a departure from U.S. GAAP must be provided to the reviewer in a timely manner to allow any issues to be promptly identified and resolved.

Uncertainties

.11 Uncertainties are matters affecting the financial statements whose outcome is expected to be resolved at a future date when conclusive evidence becomes available and that could result in a modified opinion. Uncertainties may be related to the resolution of litigation or the valuation of assets, such as real estate owned, and include the contingencies discussed in SFFAS 5, as amended by

SFFAS 12, as well as other matters (see FAM 905 for discussion of auditing accounting estimates). Absence of information related to the outcome of an uncertainty does not necessarily indicate that the audit evidence supporting management's assertions is not sufficient. Rather, the auditor's professional judgment regarding the sufficiency of the audit evidence is based on the audit evidence that is, or should be, available. If, after considering the existing conditions and available evidence, the auditor concludes that sufficient appropriate audit evidence supports management's assertions about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, an unmodified opinion ordinarily is appropriate (AU-C 705.A14).

In cases involving multiple uncertainties, the auditor may conclude that it is not possible to form an opinion on the financial statements as a whole due to the interaction and possible cumulative effects of the uncertainties (AU-C 705.A15).

The auditor should express an unmodified opinion if, in the auditor's judgment, evidence is sufficient to support management's analysis of the nature of the uncertainty and its presentation or disclosure in the financial statements. The auditor may also add an emphasis-of-matter paragraph.

Comparative Financial Statements and Comparative Information

.12 Entities subject to OMB reporting guidance are required to prepare comparative financial statements. Those not subject to the requirement may nevertheless elect to do so. When comparative financial statements are presented, the auditor's report should refer to each period for which financial statements are presented and on which an audit opinion is expressed (AU-C 700.47).

.13 When expressing an opinion on all periods presented, a continuing auditor should update the report on the financial statements of one or more prior periods, presented on a comparative basis, with those of the current period. The auditor's report on comparative financial statements should not be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to support the opinion for the most recent audit (AU-C 700.48).

.14 If comparative information is presented but not covered by the auditor's opinion, the auditor should clearly indicate in the auditor's report the character of the auditor's work, if any, and the degree of responsibility the auditor is taking (AU-C 700.49).

.15 If comparative information is presented and the auditor has been engaged to express an opinion on all periods presented, the auditor should consider whether the information included for the prior period(s) contains sufficient detail to constitute a fair presentation in accordance with the applicable financial reporting framework (generally U.S. GAAP) (AU-C 700.50).

.16 If comparative financial statements or comparative information is presented for prior periods, the auditor should determine whether the comparative financial statements or comparative information has been presented in accordance with the relevant requirements, if any, of the applicable financial reporting framework (generally U.S. GAAP) (AU-C 700.51-.52). The auditor should also evaluate

- whether the comparative financial statements or comparative information agrees with the amounts and other disclosures presented in the prior period, or when appropriate, has been restated for the correction of a material

misstatement or adjusted for the retrospective application of an accounting principle, and

- whether the accounting policies reflected in the comparative financial statements or comparative information are consistent with those applied in the current period or, if there have been changes in accounting policies, whether those changes have been properly accounted for and adequately presented and disclosed (AU-C 700.53).

.17 If the auditor becomes aware of a possible material misstatement in the comparative financial statements or comparative information while performing the current period audit, the auditor should perform such additional audit procedures as are necessary in the circumstances to obtain sufficient appropriate audit evidence to determine whether a material misstatement exists. If the auditor audited the prior period's financial statements and becomes aware of a material misstatement in those financial statements, the auditor should also follow the requirements of AU-C 560. If the prior-period financial statements are restated, the auditor should determine that the comparative financial statements or comparative information agrees with the restated financial statements (AU-C 700.54). Also see FAM 580.110 for additional guidance.

.18 As noted in FAM 1001.06, the auditor should request written representations for all periods referred to in the auditor's opinion. The auditor also should obtain a specific written representation regarding any restatement made to correct a material misstatement in a prior period that affects the comparative financial statements (AU-C 700.55).

.19 When reporting on prior period financial statements in connection with the current period's audit, if the auditor's opinion on such prior period financial statements differs from the opinion the auditor previously expressed, the auditor should disclose the following matters in an emphasis-of-matter or other matter paragraph in accordance with AU-C 706, *Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report* (AU-C 700.56):

- the date of the auditor's previous report;
- the type of opinion previously expressed;
- the substantive reasons for the different opinion; and
- that the auditor's opinion on the amended financial statements is different from the auditor's previous opinion.

.20 If the financial statements of the prior period were audited by a predecessor auditor, the auditor should follow the reporting requirements of AU-C 700.57 and .58. If comparative financial statements are presented, but the prior period financial statements were not audited, the auditor should follow the reporting requirements of AU-C 700.59 or 60, as applicable.

.21 The auditor should evaluate whether the comparability of the financial statements between periods has been materially affected by a change in accounting principle or by adjustments to correct a material misstatement in previously issued financial statements (AU-C 708.05), and determine the implications of such changes on the auditor's report, following the requirements of AU-C 708.07 through .10 and .13 through .16.

.22 The periods included in the auditor's evaluation of consistency depend on the periods covered by the auditor's opinion on the financial statements. When the auditor's opinion covers only the current period, the auditor should evaluate whether the current-period financial statements are consistent with those of the preceding period, regardless of whether the prior period's financial statements are presented. When the auditor's opinion covers two or more periods, the auditor should evaluate consistency between such periods and the consistency of the earliest period covered by the auditor's opinion with the period prior thereto, if such prior period is presented with the financial statements being reported on. The auditor should also evaluate whether the financial statements for the periods being reported on are consistent with any previously issued financial statements for those periods (AU-C 708.06).

.23 If the auditor identifies material inconsistencies between the comparative financial statements, the auditor will need to determine the effect on the auditor's opinion and include an emphasis-of-matter paragraph. The auditor should see AU-C 705, *Modifications to the Opinion in the Independent Auditor's Report*, and AU-C 708, *Consistency of Financial Statements*, for further guidance.

Report Format

.24 The auditor's report should have a title that clearly indicates that it is the report of an independent auditor and should be addressed, as appropriate, based on the circumstances of the engagement (AU-C 700.22 and .23).

.25 The auditor's report should clearly identify the entity audited; the financial statement(s) on which the auditor is reporting; and the period covered by the financial statement(s), usually the current year with comparative prior year.

.26 The auditor's report on the financial statements should include sections with the following headings in the order shown below (AU-C 700.24, .28, .31, and .34):

- Opinion
- Basis for Opinion
- Responsibilities of Management for the Financial Statements
- Auditor's Responsibilities for the Audit of the Financial Statements

If the auditor expresses a modified opinion, the auditor should modify the section headings listed above in accordance with AU-C 705. See FAM 595 B auditor's report examples.

The auditor's report on the financial statements should also include sections with the following headings, as applicable:

- Required Supplementary Information or other appropriate heading (see FAM 580.38)
- Other Information or other appropriate heading (see FAM 580.39)

.27 The auditor's report on the audit of internal control over financial reporting should include sections with the following headings in the order shown below (AU-C 940.64):

- Opinion on Internal Control over Financial Reporting
- Basis for Opinion

- Responsibilities of Management for Internal Control over Financial Reporting
- Auditor's Responsibilities for the Audit of Internal Control over Financial Reporting
- Definition and Inherent Limitations of Internal Control over Financial Reporting or other appropriate heading

.28 The auditor may choose to issue a combined report containing both an opinion on the financial statements and an opinion on internal control over financial reporting or separate reports on the entity's financial statements and on internal control over financial reporting (AU-C 940.A116). If issuing separate reports, the auditor should use the headings listed under FAM 580.26 and .27 above. If issuing a combined report, the auditor should use the headings listed below in the following order:

- Opinion on the Financial Statements
- Opinion on Internal Control over Financial Reporting
- Basis for Opinions
- Responsibilities of Management for the Financial Statements and Internal Control over Financial Reporting
- Auditor's Responsibilities for the Audits of the Financial Statements and Internal Control over Financial Reporting
- Definition and Inherent Limitations of Internal Control over Financial Reporting
- Required Supplementary Information
- Other Information

See auditor's report example 1 in FAM 595 A.

.29 Based on AU-C 700.39, other reporting responsibilities, such as the auditor's report on (1) internal control over financial reporting in which no opinion is expressed or (2) report on compliance with laws, regulations, contracts, and grant agreements, should be addressed in a separate section in the auditor's report with a heading that is appropriate to the content of the section.

The auditor's report on internal control over financial reporting in which no opinion is expressed should include a section discussing the definition and inherent limitations of internal control over financial reporting, similar to the language the auditor would include in a report on the audit of internal control over financial reporting.[11] The auditor's report on internal control over financial reporting in which no opinion is expressed should include sections with the following headings:

- Results of Our Consideration of Internal Control over Financial Reporting

[11]Although AICPA standards do not require the auditor to include the definition and inherent limitations of internal control over financial reporting in an audit report where no opinion is expressed on internal control over financial reporting, it is important for auditors of federal entities to include such information in order to provide transparency regarding the objectives and limitations of internal control over financial reporting in the federal government.

- Basis for Results of Our Consideration of Internal Control over Financial Reporting
- Responsibilities of Management for Internal Control over Financial Reporting
- Auditor's Responsibilities for Internal Control over Financial Reporting
- Definition and Inherent Limitations of Internal Control over Financial Reporting
- Intended Purpose of Report on Internal Control over Financial Reporting (see FAM 580.74)

The auditor's report on compliance with laws, regulations, contracts, and grant agreements should include sections with the following headings:

- Results of Our Tests for Compliance with Laws, Regulations, Contracts, and Grant Agreements
- Basis for Results of Tests for Compliance with Laws, Regulations, Contracts, and Grant Agreements
- Responsibilities of Management for Compliance with Laws, Regulations, Contracts, and Grant Agreements
- Auditor's Responsibilities for Tests of Compliance with Laws, Regulations, Contracts, and Grant Agreements
- Intended Purpose of Report on Compliance with Laws, Regulations, Contracts, and Grant Agreements (see FAM 580.96)

See auditor's report example 2 in FAM 595 A.

.30 Information that is not required by the applicable financial reporting framework (generally U.S. GAAP) but is nevertheless presented as part of the basic financial statements should be covered by the auditor's opinion if it cannot be clearly differentiated. Information that can be clearly differentiated may be identified as "unaudited" or as "not covered by the auditor's report" (AU-C 700.61 and .A80).

.31 The auditor's report should be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements. See FAM 580.103 for further guidance.

.32 GAGAS (2018) 6.57 requires the auditor to obtain and report the views of management concerning the findings, conclusions, and recommendations in the audit report, as well as any planned corrective actions. The entity comments and (auditor) evaluation section of the report discusses the extent to which the entity agrees with the facts and conclusions presented by the auditor and the reasons for any disagreements. The auditor should evaluate any disagreements that the entity expresses and present the auditor's view. The auditor may also outline in the report the entity's description of the efforts it is taking to correct or mitigate matters. The auditor should disclaim an opinion on this information. See FAM 580.100–.102 for further guidance.

.33 The auditor may prepare a highlights page, executive summary, and/or transmittal letter to provide a high-level presentation of the audit report and significant matters of interest to the users of federal financial reports. The auditor

typically presents matters in nontechnical language so that report users can readily grasp their significance.

Types of Reports

.34 The auditor may issue one of the following opinion types: (1) unmodified or (2) modified, which may be a qualified opinion, adverse opinion, or disclaimer of opinion. Additionally, the auditor may be required or may choose to include an emphasis-of-matter and/or other-matter paragraph as discussed below.

.35 Reporting requirements and related guidance are included in AU-C 700, 701, 705, 706, 708, 720, 725, 730, 806, and 940 and GAGAS (2018) 6.39 through 6.41. Additionally, FAM 595 A includes an example of an unmodified report. FAM 595 B includes example wording for an auditor's report with an unmodified opinion on the financial statements and an opinion on internal controls over financial reporting where a material weakness or significant deficiency is identified. The auditor may use another reporting format; however, the format should meet the requirements of the standards listed above. GAO auditors also should document the reasons for any significant deviations from the example reporting format or language in FAM 595 A or B. When findings are extensive, the auditor may modify the report format to include findings in the report and additional details in an appendix included with the report.

.36 If the auditor expresses an opinion only on a single financial statement, or specific elements, accounts, or items of a financial statement, the auditor should follow AU-C 805, *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement*.

Unmodified Opinion

.37 In an unmodified opinion on the financial statements, the auditor concludes that the financial statements are presented fairly, in all material respects, as of the specified date in accordance with U.S. GAAP (AU-C 700.18).[12] The auditor should follow the requirements of AU-C 700.22 through .43 regarding specific wording and structure of the auditor's report, as specified in FAM 595 A. Additionally, the auditor should include an emphasis-of-matter paragraph, other-matter paragraph, or both to the unmodified report in certain circumstances, as discussed below.

.38 If RSI is applicable to the entity, the auditor should include a separate section in the auditor's report on the financial statements with the heading "Required Supplementary Information," or other appropriate heading. The auditor should follow the requirements of AU-C 730.07 through .09 regarding specific wording of this section, as specified in FAM 595 A. Refer to AU-C 730.08d through .08g; .09; and .A3, illustrations 2 through 6, if (1) the auditor is unable to complete the procedures discussed in FAM 280.08, (2) some or all of the RSI is omitted, (3) the auditor has identified material departures from prescribed guidelines, or (4) the auditor has unresolved doubts about whether the RSI is measured or presented in accordance with prescribed guidelines.

[12]These are usually comparative statements for the current and prior years unless it is the entity's initial audit.

.39 If other information is presented in the annual report, at the date of the auditor's report, when the auditor has obtained all the other information included in the report, the composition of which was determined through discussion with management and for which the auditor obtained management's written acknowledgment (see FAM 280.09), the auditor should include a separate section in the auditor's report on the financial statements with the heading "Other Information" or other appropriate heading. The auditor should follow the requirements of AU-C 720.24 and .25 regarding specific wording of this section, as specified in FAM 595 A. Refer to AU-C 720.24f; .25; and .A62, illustration 2, if the auditor has concluded that an uncorrected material misstatement of the other information exists.

.40 For entities that conform to FASB standards, if, as a result of audit procedures performed as specified in AU-C 570.12 through .17, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains, the auditor should include a separate section in the auditor's report with the heading "Substantial Doubt About the Entity's Ability to Continue as a Going Concern" in accordance with AU-C 570.24 through .25. If adequate disclosure about the entity's ability to continue as a going concern for a reasonable period of time is not made in the financial statements, the auditor should modify the audit opinion in accordance with AU-C 570.26. If the financial statements have been prepared using the going concern basis of accounting, but in the auditor's judgment, management's use of the going concern basis of accounting in the preparation of the financial statements is inappropriate, the auditor should express an adverse opinion (AU-C 570.23). Refer to AU-C 570 for additional requirements pertaining to the entity's ability to continue as a going concern.

Types of Modified Opinions

.41 Pervasive effects on the financial statements are those that in the auditor's professional judgment,

- are not confined to specific elements, accounts, or items of the financial statements;
- if so confined, represent or could represent a substantial proportion of the financial statements; or
- with regard to note disclosures, are fundamental to users' understanding of the financial statements (AU-C 705.06).

The auditor should conclude whether the possible effects of undetected misstatements, if any, could be material to the financial statements and, if so, also conclude whether the possible effects are pervasive to the financial statements (AU-C 705.8b and .10).

.42 If the audit scope is adequate for expressing an opinion on the financial statements, the auditor should determine the appropriate type of opinion. The auditor should make this determination based on

a. the auditor's conclusions on whether uncorrected misstatements are material, individually or in the aggregate, to the financial statements, as discussed in FAM 540 and AU-C 450.11 (AU-C 700.13b);

b. the auditor's conclusions on whether the financial statements are prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework (generally U.S. GAAP), including consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments, as discussed in FAM 560.05 (AU-C 700.14);

c. the results of the auditor's evaluation of the financial statement disclosure of accounting policies, the selection of accounting policies, and other items specified in AU-C 700.15a through .15f, as discussed in FAM 560;

d. the results of the auditor's evaluation about whether the financial statements achieve fair presentation considering the factors in AU-C 700.16a and .16b, as discussed in FAM 560; and

e. the results of the auditor's evaluation about whether the financial statements adequately refer to or describe the applicable financial reporting framework per AU-C 700.17 and as discussed in FAM 560.

.43 The following table illustrates how the auditor's professional judgment about the nature of the matter giving rise to the modification and the pervasiveness of its effects or possible effects on the financial statements affect the type of opinion to be expressed (AU-C 705.A1).

Nature of matter giving rise to the modification	**Auditor's professional judgment about the pervasiveness of the effects or possible effects on the financial statements**	
	Material but not pervasive	**Material and pervasive**
Financial statements are materially misstated	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion	Disclaimer of opinion

.44 The auditor should modify the opinion in the auditor's report if the auditor concludes that based on the audit evidence obtained, the financial statements as a whole are materially misstated or the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement (AU-C 700.19, AU-C 705.07).

When the auditor modifies the opinion on the financial statements, the auditor should use the heading "Qualified Opinion," Adverse Opinion," or "Disclaimer of Opinion," as appropriate, for the "Opinion" section. The auditor should also amend the heading "Basis for Opinion" to "Basis for Qualified Opinion," "Basis for Adverse Opinion," or "Basis for Disclaimer of Opinion," as appropriate, and within this section of the auditor's report, include a description of the matter giving rise to the modification (AU-C 705.17 and .21).

If the auditor concludes that it is necessary to express an adverse opinion or disclaim an opinion on the entity's complete set of financial statements as a whole, an unmodified opinion on a specific element in the same auditor's report would contradict the adverse opinion or disclaimer of opinion on the entity's complete set of financial statements as a whole and would be tantamount to expressing a piecemeal opinion (which is prohibited). In the context of a separate

audit of a specific element that is included in those financial statements, when the auditor nevertheless considers it appropriate to express an unmodified opinion on that specific element, the auditor should only do so if

a. that opinion is expressed in an auditor's report that is neither published with nor otherwise accompanies the auditor's report containing the adverse opinion or disclaimer of opinion and

b. the specific element does not constitute a major portion of the entity's complete set of financial statements or the specific element is not, or is not based upon, the entity's stockholders' equity or net income or the equivalent.

A single financial statement is deemed to constitute a major portion of a complete set of financial statements. Therefore, the auditor should not express an unmodified opinion on a single financial statement of a complete set of financial statements if the auditor has expressed an adverse opinion or disclaimed an opinion on the complete set of financial statements as a whole, even if the auditor's report on the single financial statement is neither published together nor otherwise accompanies the auditor's report containing the adverse opinion or disclaimer of opinion (AU-C 705.15 and AU-C 805.21 and .22).

.45 If the auditor concludes that the financial statements do not achieve fair presentation, the auditor should discuss the matter with management and, depending on how the matter is resolved, should determine whether it is necessary to modify the opinion in the auditor's report in accordance with AU-C 705 (AU-C 700.20).

.46 Emphasis-of-matter paragraphs, other-matter paragraphs, or both may also be included in the auditor's report when the auditor expresses a qualified or adverse opinion or disclaims an opinion.

.47 If the auditor concludes that the opinion on the financial statements should be modified, the auditor should revise the auditor's report to reflect the specific wording changes required by AU-C 705.17 through .29. Specific wording is provided for qualified opinions, adverse opinions, and disclaimers of opinion.

Qualified Opinion

.48 The auditor should express a qualified opinion, as discussed in AU-C 705.08, in the following circumstances:

- the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material but not pervasive to the financial statements or
- the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

Adverse Opinion

.49 The auditor should express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements (AU-C 705.09).

Disclaimer of Opinion

.50 In a disclaimer of opinion, the auditor does not express an opinion on the financial statements. The auditor should disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive (AU-C 705.10). When the auditor disclaims an opinion on the financial statements, the auditor's report should not include an "Other Information" section in accordance with AU-C 720, *The Auditor's Responsibilities Relating to Other Information Included in Annual Reports* (AU-C 705.30).

Emphasis-of-Matter and Other-Matter Paragraph(s)

.51 As discussed in AU-C 706, the auditor should add an emphasis-of-matter and/or other-matter paragraph when certain conditions exist. Additionally, the auditor may include emphasis-of-matter and/or other-matter paragraphs in the report based on the auditor's professional judgment. Inclusion of an emphasis-of-matter paragraph does not affect the auditor's opinion, including an unmodified opinion (AU-C 706.A7).

Emphasis-of-Matter Paragraph

.52 If the auditor considers it necessary to draw users' attention to a matter appropriately presented or disclosed in the financial statements that in the auditor's professional judgment, is of such importance that it is fundamental to users' understanding of the financial statements, the auditor should include an emphasis-of-matter paragraph in the auditor's report, provided that the auditor would not be required to modify the opinion in accordance with AU-C 705 as a result of the matter (AU-C 706.08). See AU-C 706.A4 through .A8 and .A14 for additional guidance on emphasis-of-matter paragraphs.

The auditor should follow the requirements of AU-C 706.09 for specific wording and placement of emphasis-of-matter paragraphs in the auditor's report.

Other-Matter Paragraph

.53 If the auditor considers it necessary to communicate a matter other than those presented or disclosed in the financial statements that in the auditor's professional judgment, is relevant to users' understanding of the audit, the auditor's responsibilities, or the auditor's report, the auditor should do so in an other-matter paragraph in the auditor's report (AU-C 706.10). See AU-C 706.A9 through .A15 for additional guidance on other-matter paragraphs.

The auditor should follow the requirements of AU-C 706.11 for specific wording and placement of other-matter paragraphs in the auditor's report.

.54 The following is a list of conditions that may require the auditor to include an emphasis-of-matter paragraph, other-matter paragraph, or both. This is not an all-inclusive list. The auditor should refer to the related AU-C section for further requirements and guidance.

a. Subsequently discovered facts that become known to the auditor after the report release date (see FAM 580.110).

b. The accounting principles or their method of application changes between periods and the effect on the financial statements is material (see FAM 580.21).

c. Previously issued financial statements are restated to correct a material misstatement in the respective period (see AU-C 708.13).

d. Certain situations related to prior period financial statements that are audited by a predecessor auditor or are not audited (see FAM 580.20).

e. There is a departure from U.S. GAAP that has a material effect on the financial statements, and the auditor can demonstrate that the financial statements would be misleading without this departure (see FAM 580.10).

.55 The following table provides a listing of situations that could cause the auditor to modify the opinion or add an emphasis-of-matter and/or other-matter paragraph(s) to the auditor's unmodified opinion.

Situation	**FAM paragraph and further guidance**
Relating to the financial statements	
1. Insufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement (also referred to as limitations on the scope of the audit). (AU-C 705.07b)	FAM 580.48 and .50 AU-C 705 Illustration 4 (qualified) AU-C 705 Illustrations 5 and 6 (disclaimer)
2. Effects of uncertainties on an audit opinion.	FAM 580.11
3. Inconsistencies of comparability between the financial statements for all periods presented, including changes in accounting principles. (AU-C 708)	FAM 580.21–.23
4. Material departures from U.S. GAAP resulting in a qualified or adverse opinion. (AU-C 705.07a)	FAM 580.09–.10 AU-C 705 Illustrations 1 and 2 (qualified) AU-C 705 Illustration 3 (adverse)
Relating to internal control	
5. Scope limitation resulting in a disclaimer of opinion on internal control.	FAM 580.64–.65
6. Material weaknesses and significant deficiencies in a report or opinion on internal control or other control deficiencies that the auditor has decided to describe in the audit report. Additional report modification is needed if one or more material weaknesses are not included in management's report on internal control over financial reporting.	FAM 580.68–.70 FAM 595 B Example 1 (material weakness in internal control) FAM 595 B Example 2 (significant deficiency in internal control)
7. Material inconsistencies between management's FMFIA report and the results of the auditor's evaluation of internal control and systems' conformance with financial management systems requirements.	FAM 580.85

Situation	FAM paragraph and further guidance
8. Purpose of audit was not to give an opinion on internal control, and significant deficiencies or material weaknesses were found.	FAM 580.73–.74 AU-C 265
Relating to financial management systems' substantial compliance with FFMIA requirements (for CFO Act agencies)	
9. Instances of lack of entity financial management systems' substantial compliance with the three requirements of FFMIA for CFO Act agencies.	FAM 580.86–.90
Relating to compliance with significant provisions of applicable laws, regulations, contracts, and grant agreements	
10. Scope limitation—some significant provisions of applicable laws, regulations, contracts, and grant agreements could not be tested.	FAM 580.97
11. Scope limitation—all significant provisions of applicable laws, regulations, contracts, and grant agreements could not be tested—disclaimer.	FAM 580.98
12. Reportable noncompliance—instances of noncompliance with significant provisions of applicable laws, regulations, contracts, and grant agreements that are reportable under GAGAS (which incorporates U.S. GAAS) or OMB audit guidance that are not clearly inconsequential.	FAM 580.95
13. Material noncompliance with significant provisions of applicable laws, regulations, contracts, and grant agreements.	FAM 580.91–.92

Internal Control

.56 Auditors may take one of two different approaches to reporting on internal control: (1) management provides an assessment about the effectiveness of its internal control and the auditor expresses an opinion on internal control or on management's assessment following the guidance in AU-C 940 (see FAM 580.63–.72)[13] or (2) the auditor reports material weaknesses and significant deficiencies found but does not give an opinion on internal control (see FAM 580.73–.79). OMB reporting guidance requires management to include representations about internal control in the management representation letter and requires CFO Act agencies to include these representations in the MD&A in the annual report. OMB audit guidance does not require auditors to express an opinion on internal control; however, the terms of the engagement may include a requirement for an auditor to express an opinion on the effectiveness of the

[13]If the auditor finds no material weaknesses in internal control, the auditor may express an opinion on management's assessment or directly on internal control.

entity's internal control over financial reporting. In either case, the auditor should evaluate whether the design and implementation of internal control is sufficient to meet the control objectives insofar as those objectives pertain to providing reasonable assurance that a misstatement or omission in the significant assertion is prevented, or detected and corrected, on a timely basis. These control objectives are as follows:

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

Classifying Control Weaknesses

.57 A **control deficiency** exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A deficiency in design exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not designed effectively so that even if the control operates as designed the control objective would not be met. A deficiency in operation exists when an effectively designed control does not operate as designed or when the person performing the control does not possess the necessary authority or competence to perform the control effectively (AU-C 265.07). The auditor should classify internal control deficiencies following AU-C 265 as follows:

- A **significant deficiency** is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness yet important enough to merit attention by those charged with governance.
- A **material weakness** is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility[14] that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis (AU-C 265.07).[15]

To avoid confusion, the auditor should include the definitions of these terms in the auditor's report, as these definitions differ from those in other auditing standards, such as standards issued by the Public Company Accounting Oversight Board (PCAOB).

[14]A reasonable possibility exists when the likelihood of an event occurring is either reasonably possible or probable. Reasonably possible is defined as the chance of the future event or events occurring is more than remote but less than likely. Probable is defined as the future event or events are likely to occur (AU-C 265.07).

[15]This definition is used to determine whether a material weakness exists.

.58 The auditor should determine whether each control deficiency or combination of control deficiencies constitutes a significant deficiency or material weakness (AU-C 265.09). The severity of a control deficiency depends not only on whether a misstatement has actually occurred but also on the magnitude of the potential misstatement resulting from the deficiency or deficiencies and whether there is a reasonable possibility that the entity's controls will fail to prevent, or detect and correct, a misstatement of an account balance or note disclosure (AU-C 265.A6). When making this determination, the auditor should evaluate the following:

- The likelihood and magnitude of potential misstatement that would not be prevented or detected because of the control deficiencies. AU-C 265.A7 through .A10 provide examples of factors for evaluating the likelihood and magnitude of misstatement.
- Whether individual control deficiencies that affect the same line item, account, note disclosure, class of transactions, significant assertion, or component of internal control collectively result in an internal control deficiency.
- The possible mitigating effects of effective compensating controls that have been tested and evaluated as part of the financial statement audit.

.59 If the auditor determines that a deficiency, or a combination of deficiencies, in internal control is not a material weakness, the auditor should consider whether prudent officials, having knowledge of the same facts and circumstances, would likely reach the same conclusion (AU-C 265.10).

Additional guidance on evaluating identified deficiencies in internal control is provided in AU-C 265.A6 through .A12. AU-C 265.A12 includes indicators of control deficiencies that the auditor should regard as indicators of a material weakness, such as the auditor's identification of a material misstatement of the financial statements under audit that was not initially identified by the entity's internal control. Additionally, circumstances that may be considered control deficiencies, significant deficiencies, or material weaknesses are described in AU-C 265.A38. Guidance on concluding on the effectiveness of internal control and reporting findings is provided in FAM 580.67 through .71.

.60 OMB Circular No. A-123 provides guidance for management to report control weaknesses under 31 U.S.C. § 3512(c), (d), commonly known as the Federal Managers' Financial Integrity Act of 1982 (FMFIA). The term material weakness as used by OMB (FMFIA material weakness) is different from the above definition and includes matters of an operational nature. Management and the auditor should evaluate the material weaknesses reported under FMFIA to determine whether they meet the auditor's definitions of material weakness and significant deficiency for reporting as part of management's assessment about the effectiveness of internal control (see FAM 580.85).

.61 For controls other than financial reporting controls, a weakness is an FMFIA material weakness if it is significant enough to be reported outside the entity, as determined by the entity head. That is, it was included in the annual FMFIA report to the President and the Congress. Entity reporting of system noncompliance is governed by the criteria for FFMIA reporting in OMB Circular No. A-123, Appendix D.

.62 The auditor should determine how threats, incidents, and risk assessments reported in a Federal Information Security Modernization Act of 2014 annual

report regarding major incidents relate to the control deficiencies identified during the financial statement audit.

Opinion on Internal Control

.63 Although not required by OMB audit guidance, if the auditor plans to express an opinion on internal control, the auditor's evaluation of the entity's internal control and the results of other audit procedures form the basis for this opinion. The opinion may be (1) unmodified, (2) unmodified with reference to significant deficiencies, (3) disclaimer, or (4) adverse (one or more material weaknesses). Additionally, there may be restrictions on the scope of the procedures that result in a disclaimer of opinion (see FAM 580.65). The auditor should communicate any identified internal control deficiencies, including weaknesses in operations controls, and consider the effects of these deficiencies on other entity-prepared reports (see FAM 580.68–.71 and .80–.84).

Scope of Procedures

.64 When performing an audit of internal control over financial reporting, the auditor should do the following:

a. Obtain the agreement of management that it acknowledges and understands its responsibility for the following (AU-C 940.06a):

   i. designing, implementing, and maintaining effective internal control over financial reporting;

   ii. evaluating the effectiveness of the entity's internal control over financial reporting using suitable and available criteria;

   iii. providing management's assessment about internal control over financial reporting in a report that accompanies the auditor's report;

   iv. supporting its assessment about the effectiveness of the entity's internal control over financial reporting with sufficient evaluations and documentation; and

   v. providing the auditor with (1) access to all information of which management is aware that is relevant to management's assessment of internal control over financial reporting, such as records, documentation, and other matters; (2) additional information that the auditor may request from management for the purpose of the audit of internal control over financial reporting; and (3) unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

b. Determine that the date specified in management's assessment about the effectiveness of internal control over financial reporting corresponds to the balance sheet date (or period ending date) of the period covered by the financial statements (AU-C 940.04a and .06b).

The auditor should evaluate the effectiveness of the entity's internal control over financial reporting using the same suitable and available criteria used by management for its assessment (AU-C 940.07). In accordance with FAM 580.64a.iii above, the auditor should request from management a written assessment about the effectiveness of the entity's internal control over financial reporting. Management's refusal to provide a written assessment represents a

scope limitation, and the auditor should apply the requirements in AU-C 940.74 through .77 (AU-C 940.08).

The auditor should perform all necessary procedures, as described in FAM 300 and FAM 450, on the written assessment from management. The auditor should evaluate whether management has a reasonable basis for its assessment. For example, the assessment may be based on management's monitoring procedures (see AU-C 940.A10 through .A13 for evidence that management can use to support its assessment). The audit results alone cannot be the basis for management's assessment.

.65 If there is a restriction on the scope of the audit, such that not all of these procedures can be performed, the auditor should evaluate whether or not to disclaim the opinion on internal control over financial reporting and determine whether or not to modify the GAGAS compliance statement in the report, as discussed in GAGAS (2018) 2.17b, 2.18, and 2.20. Scope restrictions may be imposed by the entity or may be due to other circumstances. The auditor's decision regarding a scope limitation on internal control must be provided to the reviewer in timely manner to allow any issues to be promptly identified and resolved.

When determining the severity of a scope limitation on internal control, the auditor should use the control objectives listed in the report for internal control over financial reporting, including safeguarding assets. If the scope of work on internal control over financial reporting is limited, the auditor should disclaim the opinion on internal control. If the auditor concludes that the auditor cannot express an opinion because there has been a limitation on the scope of the examination, the auditor should communicate, in writing, to management and those charged with governance that the audit of internal control over financial reporting cannot be satisfactorily completed.

.66 If the auditor determines that an opinion can be expressed, the type of opinion depends on whether any internal control deficiencies are identified and the significance of such deficiencies. In identifying and evaluating deficiencies, the auditor should consider deficiencies in each of the five components of internal control (control environment, entity risk assessment, information and communications, control activities, and monitoring). In concluding on the effectiveness of internal control, the auditor should categorize control deficiencies, in order of decreasing significance, as (1) material weaknesses, (2) significant deficiencies, and (3) other deficiencies that do not meet the criteria for a significant deficiency or material weakness (other deficiencies). Each of these types of weaknesses and its effects on the auditor's conclusion on internal control is discussed below. If no material weaknesses are identified, the auditor generally should conclude that internal control is effective in meeting the control objectives.

Effects of Control Deficiencies on the Auditor's Conclusion on the Effectiveness of Internal Control over Financial Reporting

.67 Based on the types of deficiencies noted, the auditor should conclude on the effectiveness of internal control over financial reporting as of the end of the audit period, as discussed below. Management also should conclude on the effectiveness of internal control in deciding what assessment to make. After forming an opinion on the effectiveness of the entity's internal control, the auditor

should evaluate management's report to determine whether it appropriately contains the following (AU-C 940.55):

- a statement regarding management's responsibility for internal control over financial reporting;
- a description of the subject matter of the examination (for example, controls over the preparation of the entity's financial statements in accordance with U.S. GAAP);
- an identification of the criteria against which internal control over financial reporting is measured (for example, criteria established in the GAO's *Standards for Internal Control in the Federal Government* or the Committee of Sponsoring Organizations of the Treadway Commission's *Internal Control – Integrated Framework*);
- management's assessment about the effectiveness of internal control over financial reporting;
- a description of the material weaknesses, if any; and
- the date as of which management's assessment of internal control over financial reporting is made.

When management includes, either within management's report or in a document containing management's report and the related auditor's report, information in addition to the elements that are subject to the auditor's evaluation as described above, the auditor should perform the procedures required by AU-C 940.80. If the auditor determines that any required element of management's report is incomplete or improperly presented, the auditor should request management to revise its report (AU-C 940.56). If management does not revise its report, the auditor should modify the auditor's report to include an other-matter paragraph describing the reasons for this determination (AU-C 940.72).

Material Weaknesses

.68 If one or more material weaknesses exist at the end of the audit period, the auditor should conclude that the entity's internal control is ineffective, which would result in an adverse opinion (AU-C 940.68). The existence of a material weakness precludes a conclusion that internal control is effective, which would result in a modified opinion. The auditor's report should include in the "Basis for Adverse Opinion on Internal Control over Financial Reporting" section (a) the definition of a material weakness and (b) a statement that one or more material weaknesses have been identified and an identification of the material weaknesses described in management's assessment about internal control over financial reporting (AU-C 940.70).

If one or more material weaknesses have not been included in management's report accompanying the auditor's report, the auditor's report should be modified to state that one or more material weaknesses have been identified but not included in management's report. Additionally, the auditor's report should include a description of each material weakness not included in management's report. The auditor's description should include specific information about the nature of each material weakness and its actual and potential effect on the presentation of the entity's financial statements issued during the existence of the weakness. In this case, the auditor also should communicate, in writing, to those charged with governance that one or more material weaknesses were not disclosed or

identified as a material weakness in management's report. If one or more material weaknesses have been included in management's report but the auditor concludes that the disclosure of such material weaknesses is not fairly presented in all material respects, the auditor's report should describe this conclusion as well as the information necessary to fairly describe each material weakness (AU-C 940.71).

.69 The auditor should determine the effect an adverse opinion on internal control over financial reporting has on the auditor's opinion on the financial statements. Additionally, the auditor should disclose, as a separate paragraph within the "Adverse Opinion on Internal Control over Financial Reporting" section of the report, whether the auditor's opinion on the financial statements was affected by the material weakness (AU-C 940.69). If a material weakness is presented in a report that also includes an unmodified opinion on the financial statements, the auditor should add a statement to the unmodified opinion to indicate that as a result of a material weakness, material misstatements may nevertheless occur in other financial information reported by the entity. Example report modifications for material weaknesses are provided in FAM 595 B.

Significant Deficiencies

.70 If significant deficiencies existed at the end of the audit period, but no material weaknesses were identified, the auditor generally should conclude that the controls are effective in achieving the control objectives. However, as required by GAGAS, the auditor should indicate in the report that the work performed identified significant deficiencies and should describe the deficiencies (see FAM 595 B).

Control Deficiencies That Do Not Meet the Criteria for Material Weaknesses or Significant Deficiencies

.71 Control deficiencies that do not meet the criteria for material weaknesses or significant deficiencies in FAM 580.57 do not affect the auditor's conclusion on the effectiveness of internal control. The auditor also should communicate to management at an appropriate level of responsibility—on a timely basis either in writing (e.g., in a separate report to management or a write-up of the deficiency to management for its concurrence with the facts) or orally—these deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that in the auditor's professional judgment, are of sufficient importance to merit management's attention. If these deficiencies in internal control are communicated orally, the auditor should document the communication (AU-C 265.12b). This communication should be made no later than 60 days following the report release date (AU-C 265.13). The auditor should document any oral communication of these deficiencies. When performing an integrated audit, the auditor should communicate these deficiencies in writing and inform those charged with governance when such communication was made. The auditor is not required to communicate those deficiencies that are not material weaknesses or significant deficiencies that were included in previous written communications, regardless of whether those communications were made by the auditor, internal auditors, or others within the organization (AU-C 940.62).

Type of Opinion

.72 As described in FAM 580.65, if the auditor is unable to apply all the audit procedures considered necessary in the circumstances, a scope limitation exists and the auditor should issue a disclaimer of opinion on internal control over financial reporting in accordance with AU-C 940.75 and .76. If all the procedures considered necessary were performed, the auditor should issue one of the following opinions:

- If the auditor and management agree on the effectiveness of internal control and there are no material weaknesses, the auditor should issue an unmodified opinion on internal control (see FAM 595 A).
- If the auditor and management agree on the effectiveness of internal control and there are no material weaknesses in internal control, but there are significant deficiencies, the auditor should issue an unmodified opinion, including a statement that internal control is effective but could be improved and referring to the significant deficiencies (see FAM 595 B).
- If the auditor and management agree on the effectiveness of internal control and there *are* material weaknesses in internal control, the auditor should modify the opinion on internal control by (1) referring to the material weakness(es) noted in management's assessment (which states that internal control over financial reporting is ineffective (adverse opinion)) and (2) describing the material weakness(es) (see FAM 595 B). OMB Circular No. A-123 guidance for FMFIA allows management to provide a qualified assessment of internal control effectiveness even if material weaknesses exist.
- If the auditor and management disagree on the effectiveness of internal control, either because (1) management does not agree that material weakness(es) exist or (2) management does not appropriately modify its assessment about the effectiveness of internal control in light of the material weakness(es), the auditor should issue an adverse opinion. The existence of a material weakness precludes management from asserting that its internal control is effective. Thus, an adverse opinion is appropriate if management states that internal control is effective "except for" the material weakness when, in the auditor's professional judgment, the material weakness indicates that internal control is ineffective (see FAM 580.68).

Nonopinion Report

.73 If the purpose of the audit is not to express an opinion on internal control, the auditor should still report any identified material weaknesses and significant deficiencies in internal control in accordance with AU-C 265.11 through .16. Per OMB audit guidance, if the auditor did not identify any material weaknesses during the audit, the auditor should state, in the report on internal control, that no deficiencies in internal control were identified that were considered to be material weaknesses during the audit of the financial statements and include matters required by AU-C 265.15 (see auditor's report example 2 in FAM 595 A). Including a statement in the report on internal control indicating that no material weaknesses were identified during the audit does not provide any assurance about the effectiveness of an entity's internal control over financial reporting (AU-C 265.A35). The auditor should not issue a written communication stating that no significant deficiencies were identified during the audit because of the potential

for users to misinterpret the amount of assurance provided by such communication (AU-C 265.16). If there are one or more material weaknesses, the auditor may state in its report that internal control was ineffective for one or more objectives. Further, the auditor should conclude whether the scope of the work and the related audit evidence are sufficient to meet the audit objectives described in the OMB audit guidance. If the work is not sufficient, the auditor should report a scope limitation.

.74 Based on AU-C 905, *Alert That Restricts the Use of the Auditor's Written Communication*, a report on internal control in which no opinion is expressed is considered a by-product report of a financial statement audit. Based on AU-C 905.11, because the distribution of government audit reports is not restricted, the report on internal control should include an alert, in a separate paragraph, to (1) describe the purpose of the report and (2) state that the report is not suitable for any other purpose. See FAM 595 A, example 2, for an auditor's report example that includes this alert.

Where and When to Report Control Deficiencies for Nonopinion Report

.75 The means of communicating deficiencies in internal control depends on the type of weakness, as discussed in FAM 580.57. The auditor should communicate in writing to those charged with governance on a timely basis significant deficiencies and material weaknesses identified during the audit, including those that were remediated during the audit (AU-C 265.11). The auditor also should communicate to management at an appropriate level of responsibility, on a timely basis in writing, significant deficiencies and material weaknesses that the auditor has communicated or intends to communicate to those charged with governance, unless it would be inappropriate to communicate directly to management in the circumstances (AU-C 265.12a). This communication is part of the auditor's report on financial statements (GAGAS (2018) 6.40). For other deficiencies, the auditor should communicate no later than 60 days following the report release date. However, the auditor may issue other written communication containing further details on the deficiencies. The auditor should include any material weaknesses or other significant deficiencies that were communicated in previous financial statement audits that have not yet been corrected. The auditor may do this by referring to the previously issued written communication and the date of the communication. Communicating each type of deficiency is discussed below.

Material Weaknesses and Significant Deficiencies

.76 The auditor should report material weaknesses and significant deficiencies in the internal control section of the auditor's report. The auditor may report these deficiencies in a separate report that is referenced to in the auditor's report on the financial statements. If management's assessment about the effectiveness of internal control is printed with the audit report, the auditor's report should refer to the discussion of the material weakness (or other significant deficiency) in management's assessment.

.77 The auditor generally should limit the internal control section of the auditor's report to summarized information. As such, the auditor may limit the discussion of control deficiencies included in this section to providing the reader with an understanding of the nature and extent of the deficiency. The auditor may combine related control deficiencies. To the extent that any such control

deficiencies contribute to a significant deficiency, the auditor generally should describe them in conjunction with the related significant deficiency.

.78 If more complete information concerning control deficiencies is provided in other reports issued prior to or at the same time as the auditor's report, the auditor generally should refer to such other reports (such as date and title or report number) in the auditor's report. The auditor may also subsequently report significant deficiencies in more detail in a separate report to management or other written communication that includes other elements of the findings, as discussed in FAM 580.81.

Other Control Deficiencies

.79 The auditor should communicate to management at an appropriate level of responsibility, on a timely basis in writing or orally, other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that in the auditor's professional judgment, are of sufficient importance to merit management's attention. If other deficiencies in internal control are communicated orally, the auditor should document the communication (AU-C 265.12b).

What to Report about Control Deficiencies

.80 Control deficiencies identified by the auditor are findings. GAGAS (2018) 6.25 through 6.28 describe the four elements of a finding:

- **Criteria** (what should be).
- **Condition** (what is).
- **Cause** (why the condition occurred).
- **Effect** (the nature of the possible past or future impact).

.81 The auditor should decide whether to fully develop each of the four elements of a finding. The auditor uses professional judgment in determining whether to apply resources to investigate a control deficiency, based on the elements that the auditor decides to report. For each significant deficiency, the extent to which the auditor should develop the elements of a finding depends on how it is communicated.

- **Material weaknesses and significant deficiencies reported in the auditor's report.** The auditor generally should identify at least the criteria, condition, cause, and possible asserted effect (related to the nature, not necessarily amount) to permit management to determine the effect and to take prompt and proper corrective action. The auditor may provide recommendations to improve internal control and obtain management's response as part of entity comments on the auditor's report.
- **Significant deficiencies described briefly in the auditor's report and detailed in a separate report to management.** The auditor should identify at least the condition and the criteria and generally should identify the possible asserted effect to bring them to management's attention, particularly if there are sensitive or information technology issues. The auditor may also evaluate the benefits of identifying the cause. The auditor generally should provide recommendations or suggestions to improve reported findings and obtain management's response as part of entity comments on the auditor's report.

In discussing each material weakness that meets FMFIA reporting criteria, the auditor should determine whether the material weakness was identified in the entity's FMFIA report or in the FMFIA report of the organization of which the entity is a part (see FAM 580.85).

.82 For control deficiencies that do not meet the criteria for a material weakness or significant deficiency, the auditor need not develop all of the elements of a finding if the auditor decides to report these control deficiencies.

Other Considerations

.83 To communicate findings promptly, the auditor may issue written communications during the audit. For example, GAO issued a report to a federal entity where on an interim basis some installations were reporting in millions of dollars and others in billions of dollars, causing materially inaccurate consolidations of amounts. GAO issued this report to provide information so that the entity could improve the consistency and accuracy of amounts in time for year-end reporting. In such instances, the auditor may describe the control deficiency and refer to the reports as discussed in FAM 580.78.

.84 The auditor should determine whether internal control deficiencies, particularly material weaknesses, could affect information in other reports generated by the entity for external distribution or internal decision-making. The auditor generally should make inquiries and evaluate other knowledge obtained during the audit concerning use of reports affected by these deficiencies. The auditor uses professional judgment to determine whether such reports might contain inaccuracies as a result of control deficiencies that would likely influence the judgment of report users. If so, the auditor generally should describe, in the auditor's report, the nature of such reports and the effect of control deficiencies on them. In determining if such reports are significant, the auditor should evaluate whether user judgments or management decisions based on such reports could affect the entity in amounts that would be material in relation to the financial statements.

Reporting on Management's FMFIA Reports

.85 In the internal control section of the auditor's report, the auditor should disclose whether material weaknesses or financial management systems' nonconformance with financial systems requirements identified during the audit was identified in management's FMFIA report.

If the auditor found material weaknesses or systems' nonconformance that should have been reported under FMFIA, the auditor should refer to such findings as indicated in FAM 580.60 and .61 and determine whether management's FMFIA process has deficiencies that the auditor should report. Such deficiencies might result from the following:

- Management did not initially recognize internal control deficiencies or systems' nonconformance, perhaps due to a lack of training, understanding, or limitations in the scope of the FMFIA process. For example, certain areas were not reviewed annually or certain types of controls or systems were not reviewed.
- Management did not recognize that identified deficiencies were FMFIA material weaknesses or systems' nonconformance.
- Management relied on controls that the auditor concluded were ineffective.

- Management failed to report identified deficiencies due to inappropriate report preparation. This could occur because of errors in aggregating the internal control deficiencies or systems' nonconformance of individual components or locations.

The auditor may refer to the assessment of management's FMFIA process performed during planning, as discussed in FAM 260.39 through .45, when concluding on how to report these matters.

Financial Management Systems

.86 FFMIA requires the auditor to report whether the financial management systems of the 24 CFO Act agencies comply substantially with three federal financial management systems requirements. These requirements are as follows:

- federal financial management systems requirements, including those found in the *Treasury Financial Manual*, volume 1, part 6, chapter 9500, *Revised Federal Financial Management System Requirements*;
- applicable federal accounting standards; and
- the USSGL at the transaction level.

Further information on FFMIA compliance can be found in OMB Circular No. A-123, appendix D.

The auditor should conclude on whether the agency's financial management systems complied substantially with the three FFMIA requirements, following the guidance provided in FAM 701 and by OMB.

Reporting on Systems' Substantial Compliance with FFMIA Requirements

.87 If the auditor is required to report whether an agency's financial management systems comply with the three FFMIA requirements, the example reports in FAM 595 A should be revised to include this item. OMB audit guidance provides information for reporting on FFMIA compliance without expressing an opinion.

.88 If the auditor finds that the entity's financial management systems do not comply substantially with any of the three FFMIA requirements, the auditor should summarize the lack of substantial compliance in the auditor's report. Frequently, the financial management systems' lack of substantial compliance is related to significant deficiencies in internal control. If so, the auditor may make reference to another report or another section within a combined report, as necessary.

.89 If the auditor finds that the entity's financial management systems did not comply substantially with the requirements, FFMIA requires the auditor to identify the entity or organization responsible for the systems found not to comply. The auditor should include pertinent facts, such as the nature and extent of noncompliance, areas in which there is substantial but not full compliance, primary reason or cause, and any relevant comments from management or responsible employees. The auditor may make recommendations for corrective actions and obtain management's response as part of agency comments on the auditor's report.

Scope of Procedures

.90 If the auditor is unable to perform all the procedures considered necessary, as discussed in FAM 350, the scope of the financial statement audit is restricted.

Generally, if the scope of the financial statement audit is restricted, for example, because needed information from the systems is not available, the auditor should report that the financial management systems do not comply substantially with FFMIA requirements. Also, if the auditor concluded that the systems did not comply substantially with FFMIA based on limited testing, the auditor should report that the work on FFMIA would not necessarily disclose all instances of noncompliance with FFMIA requirements.

Compliance with Applicable Laws, Regulations, Contracts, and Grant Agreements and Instances of Fraud

.91 The auditor should report on the results of compliance testing and on compliance matters (including fraud, as discussed in FAM 540.24–.28) that come to the auditor's attention during procedures other than compliance tests.

If the auditor concludes that the noncompliance has a material effect on the financial statements, and it has not been adequately reflected in the financial statements, the auditor should express a qualified or adverse opinion on the financial statements (AU-C 250.24). If the auditor is precluded by management or those charged with governance from obtaining sufficient appropriate audit evidence to evaluate whether noncompliance that may be material to the financial statements has, or is likely to have, occurred, the auditor should express a qualified opinion or disclaim an opinion on the financial statements on the basis of a limitation on the scope of the audit (AU-C 250.25). If the auditor is unable to determine whether noncompliance has occurred because of limitations imposed by circumstances rather than by management or those charged with governance, the auditor should evaluate the effect on the auditor's opinion (AU-C 250.26). See FAM 580.41 through .50 for guidance on modifications to the audit opinion.

.92 If the auditor concludes, based on sufficient appropriate evidence, that any of the following have occurred or are likely to occur, the auditor should include in the report on internal control or compliance the relevant information about

- fraud that is material, either quantitatively or qualitatively, to the financial statements or other financial data significant to the audit objectives or
- noncompliance with provisions of laws, regulations, contracts, or grant agreements that has a material effect on the financial statements or other financial data significant to the audit objectives (GAGAS (2018) 6.41), regardless of whether the noncompliance has been appropriately reflected in the financial statements.

The auditor should consult with the entity's legal counsel regarding conclusions on the entity's compliance with provisions of applicable laws, regulations, contracts, and grant agreements.

.93 When the auditor identifies or suspects instances of fraud or noncompliance with provisions of laws, regulations, contracts, or grant agreements that have an effect on the financial statements or other financial data significant to the audit objectives that is less than material but warrants the attention of those charged with governance, the auditor should communicate those findings in writing to audited entity officials (GAGAS (2018) 6.44). When the auditor identifies or suspects any instances of noncompliance with provisions of applicable laws, regulations, contracts, or grant agreements that do not warrant the attention of those charged with governance, the auditor's determination of whether and how

to communicate such instances to audited entity officials is a matter of professional judgment (GAGAS (2018) 6.48).

.94 When the auditor identifies or suspects either noncompliance with provisions of laws, regulations, contracts, or grant agreements or instances of fraud, the auditor may consult with authorities or legal counsel about whether publicly reporting such information would compromise investigative or legal proceedings. The auditor may limit 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 (GAGAS (2018) 6.49).

Reporting on Compliance Tests

.95 The auditor should state directly whether any reportable noncompliance was detected during compliance tests. This type of direct statement is illustrated in FAM 595 A for a situation in which the compliance tests disclosed no reportable noncompliance. If the auditor identifies any reportable noncompliance, the auditor should modify the statement, and the auditor should discuss the reportable noncompliance in the auditor's report as described above.

.96 Based on AU-C 905, a report on compliance is considered a by-product report of a financial statement audit. Based on AU-C 905.11, because the distribution of government audit reports is not restricted, the report on compliance should include an alert, in a separate paragraph, to (1) describe the purpose of the report and (2) state that the report is not suitable for any other purpose. See FAM 595 A and B for auditor's report examples that include this alert.

Scope of Procedures

.97 The auditor should perform all of the procedures considered necessary to test compliance with significant provisions of applicable laws, regulations, contracts, and grant agreements. If the auditor is unable to perform all of the necessary procedures for one or more significant provisions, the auditor should report based on the provisions tested. However, the auditor should modify the report, as appropriate, to alert the reader that not all of the significant provisions of applicable laws, regulations, contracts, and grant agreements were tested.

.98 If the scope limitation is so significant that the auditor believes that any discussion of testing could be misleading, the auditor should report that the auditor could not test compliance due to the scope limitation. The auditor should describe significant scope limitations in the auditor's report and should modify the auditor's report. The auditor also should determine the effect of such a scope limitation on the auditor's opinion on the financial statements.

.99 If deficiencies in compliance controls are identified but no instances of noncompliance are found during compliance testing, the auditor should determine whether additional controls or mitigating factors prevented or detected instances of noncompliance. If sufficient additional controls or mitigating factors are not identified, the auditor should consult with OGC to determine the appropriate reporting of such deficiencies and compliance tests. The auditor's determinations must be provided to the reviewer in a timely manner to allow any issues to be promptly identified and resolved.

Entity Comments

.100 The auditor should obtain and report the views of responsible entity officials concerning the findings, conclusions, recommendations, and planned corrective actions, if included. The auditor should allow the audited entity to review a draft of the report prior to issuance and provide either written or oral comments. This entity review helps the auditor to identify any errors in fact; avoid surprises in the message; and strive for fairness, balance, objectivity, accuracy, and completeness. Written comments are generally preferred, especially when the report is sensitive or controversial, when significant disagreements exist, or when the report makes wide-ranging recommendations. When the entity provides written comments, the auditor should include a copy of these comments or summarize the comments in the auditor's report.

Oral comments may be appropriate when (1) there is a reporting date critical to meeting a user's needs; (2) the auditor has worked closely with the entity so that it is familiar with the findings and issues addressed in the draft report; or (3) the auditor does not expect major disagreements with the findings, conclusions, or recommendations in the draft report or major controversies with regard to the issues discussed in the draft report. If the entity provides only oral comments, the auditor should prepare a summary of these comments and provide a copy of the summary to the responsible officials to verify that the comments are accurately stated, and may report the entity's views. If the report is unmodified and does not include any material weaknesses or material noncompliance, the entity may decide not to comment.

.101 The auditor generally should include an entity comments and (auditor's) evaluation section in the auditor's report. The auditor generally should briefly characterize the overall response to the draft regarding facts and conclusions, such as whether the entity generally agrees, partially agrees, or disagrees with the report. The auditor generally should summarize the major points made in the comments, whether written or oral, usually in the last section of the auditor's report, and should include an evaluation of the comments, as appropriate. If entity officials concurred with all the findings, conclusions, and recommendations, the auditor should state that they concurred, mention any actions the entity has agreed to take, and provide the auditor's response to those actions. If entity officials disagree with or have concerns regarding portions of the report, the auditor should discuss these concerns in the auditor's report and provide the auditor's evaluation of them.

.102 The auditor generally should include the entity's written comments as an appendix to the report. These comments may include, for example, a description of corrective actions taken by the entity, the entity's plans to implement new controls, or a statement indicating that management believes the cost of correcting a significant deficiency or material weakness would exceed the benefits to be derived from doing so. If these types of comments are included in the document containing the auditor's written communication regarding material weaknesses or other significant deficiencies, the auditor should disclaim an opinion on such information.

Auditor's Report Date, Report Release Date, and Documentation Completion Date

Auditor's Report Date

.103 The auditor's report should be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements, including evidence of the following (AU-C 700.43):

- All the statements and notes that the financial statements comprise have been prepared.
- Management has asserted that it has taken responsibility for those financial statements.

.104 For comparative financial statements, the auditor's report should not be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to support the opinion for the most recent audit (AU-C 700.48).

.105 If the auditor identifies a material subsequent event for disclosure in the report, as discussed in FAM 550.04 through .05, the auditor should follow guidance in AU-C 560 with respect to report dating.

.106 The engagement partner should take responsibility for reviews being performed in accordance with the audit organization's review policies and procedures (AU-C 220A.18). On or before the date of the auditor's report, the engagement partner should, through a review of the audit documentation and discussion with the engagement team, be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued (AU-C 220A.19).

.107 Based on AU-C 220A.A25, if the auditor identifies instances after the auditor's report date but before the report release date where additional procedures or evidence is necessary, the auditor should change the date of the auditor's report to the date that the additional procedures have been satisfactorily completed or the additional evidence has been obtained (see FAM 590.02 for documentation requirements). However, if additional procedures or evidence obtained are the result of facts discovered between the auditor's report date and report release date, the auditor should follow the requirements in AU-C 560.12 through .14.

Report Release Date

.108 The report release date is the date the auditor grants the entity permission to use the auditor's report in connection with the financial statements (AU-C 230.06). Often, this will be the date that the auditor provides the audit report to the entity. The report release date will ordinarily be a date that is close to the auditor's report date. The report release date is important because it starts the period when the auditor should complete the audit documentation. If there are delays in releasing the report, the auditor should perform additional procedures to comply with AU-C 560 and AU-C 700.

Documentation Completion Date

.109 The documentation completion date is the date on which the auditor has assembled for retention a complete and final set of documentation in an audit file

(AU-C 230.06). The auditor should assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis, no later than 60 days following the report release date (AU-C 230.16). See FAM 590.03 for additional guidance.

Restatement of Audited Financial Statements

.110 If the auditor becomes aware of information or subsequently discovered facts after the report release date, the auditor should follow AU-C 560.15 through .18. SFFAS 21, *Reporting Corrections of Errors and Changes in Accounting Principles*, addresses restatement of prior-year federal entity financial statements. AU-C 708 (on consistency of financial statements) and AU-C 560 (on subsequent events and subsequently discovered facts) provide guidance on when to reissue auditor's reports on restated financial statements. Additionally, OMB reporting guidance requires management to notify its auditor when material errors are found in published financial statements and provides guidance regarding note disclosure of restatements.

590 – Documentation

.01 As discussed in FAM 290.01, the auditor should prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand

- the nature, timing, and extent of the audit procedures performed to comply with GAGAS, including the AICPA Statements on Auditing Standards and applicable attestation standards, and applicable legal and regulatory requirements;
- the results of the audit procedures performed and the audit evidence obtained; and
- the significant findings or issues arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions.

The audit documentation should include, but is not limited to

a. audit summary memorandum (FAM 590.05–.06);

b. overall analytical procedures (FAM 590.07);

c. deficiencies in internal control (FAM 590.08);

d. evaluation and communication of misstatements (FAM 540);

e. responses from the entity's legal counsel (FAM 1002);

f. subsequent events (FAM 1005);

g. management representations (FAM 1001);

h. names of identified disclosure entities, related parties, and public-private partnerships and the nature of the relationships (AU-C 550.30);

i. procedures performed to determine consistency of the other information in the annual report with the financial statements and in accordance with U.S. GAAP or OMB reporting guidance, currently OMB Circular No. A-136, and the final version of the other information on which the auditor has performed the work (FAM 280.09 and AU-C 720.26);

j. evidence of exit conference(s) (FAM 590.15);

k. applicable audit completion checklists (FAM 1003); and

l. report release date (AU-C 230.15).

.02 If, in rare circumstances, the auditor performs new or additional audit procedures or draws new conclusions after the date of the auditor's report, the auditor should document

a. the circumstances encountered;

b. the new or additional audit procedures performed, audit evidence obtained, and conclusions reached, and their effect on the auditor's report; and

c. when and by whom the resulting changes to audit documentation were made and reviewed (AU-C 230.14).

Examples of these circumstances include the following (AU-C 230.A23):

- when, after the date of the auditor's report, the auditor becomes aware of facts that existed at the date and, which if known at that date, might have caused the financial statements to be revised or the auditor to modify the opinion in the auditor's report (see FAM 550.06) and
- when the auditor concludes that procedures necessary at the time of the audit, in the circumstances then existing, were omitted from the audit of the financial statements (see FAM 580.107).

.03 The auditor should assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis, no later than 60 days following the report release date (AU-C 230.16). After the documentation completion date, the auditor should not delete or discard audit documentation of any nature before the end of the specified retention period. Such retention period, however, should not be shorter than 5 years from the report release date (AU-C 230.17).

.04 In circumstances other than those discussed in FAM 590.02 in which the auditor finds it necessary to modify existing audit documentation or add new audit documentation after the documentation completion date, the auditor should, regardless of the nature of the modifications or additions, document

a. the specific reasons for making the changes and
b. when and by whom they were made and reviewed (AU-C 230.18).

Specific Documentation Considerations

Audit Summary Memorandum

.05 At the completion of the audit, the auditor should prepare an audit summary memorandum that summarizes the audit results and demonstrates the adequacy of the audit procedures, appropriateness and sufficiency of the audit evidence, and the reasonableness of the conclusions on

- the financial statements;
- internal control;
- the financial management systems' substantial compliance with FFMIA requirements (for CFO Act agencies);
- the entity's compliance with significant provisions of applicable laws, regulations, contracts, and grant agreements;
- RSI, including MD&A; and
- other information.

.06 In the audit summary memorandum, the auditor may refer to other documentation that describes this information in more detail. The auditor generally should summarize and refer in the documentation to

a. any significant changes from the auditor's original assessment of materiality for the financial statements as a whole and the risks of material misstatement;
b. any additional fraud risks or other conditions beyond those considered in planning (FAM 265), including analytical relationships identified during the

audit that caused the auditor to believe that additional audit procedures or any other response was required, as well as any further response the auditor concluded was appropriate;

c. the results of the procedures performed to specifically address the risk of management override of controls, including the consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments (AU-C 240.44b and 700.14);

d. the work performed that demonstrates information in the financial statements agrees or reconciles with the underlying accounting records, including agreeing or reconciling note disclosures, whether such information is obtained from within or outside of the general and subsidiary ledgers (AU-C 330.33);

e. the auditor's evaluation of misstatements that the auditor believes are or might be the result of fraud;

f. the nature of any communications about fraud or possible fraud (and any significant abuse) made to management, those charged with governance, the Special Investigator Unit, the Office of Inspector General, or others (AU-C 240.45);

g. the auditor's summary conclusions related to the consideration of fraud;

h. significant accounting, auditing, or reporting issues;

i. how the auditor addressed inconsistencies if the auditor identified information that is inconsistent with the auditor's final conclusion regarding a significant finding or issue (AU-C 230.12);

j. any limitations on the audit scope;

k. the auditor's conclusions, at the financial statement and assertion levels, on whether the audit evidence obtained is sufficient and appropriate, and supports the auditor's reports on the financial statements, RSI (including MD&A), and other information included in the annual report; internal control over financial reporting; financial management systems' substantial compliance with the three FFMIA requirements (for CFO Act agencies); and compliance with significant provisions of applicable laws, regulations, contracts, and grant agreements;

l. the auditor's conclusions on whether sufficient appropriate audit evidence was obtained to reduce audit risk to an appropriately low level;

m. the auditor's conclusion on whether the audit was performed in compliance with GAGAS, OMB audit guidance, and, if used, the FAM, and whether the report is appropriate;

n. the auditor's conclusion on whether the entity's financial statements are in accordance with U.S. GAAP;

o. significant subsequent events, if any;

p. findings with respect to transactions with disclosure entities, related parties, and public-private partnerships and complex or unusual transactions (AU-C 940.54c.);

q. the summary of uncorrected misstatements, the summary of corrected misstatements (FAM 595 C), communication of the misstatements to

management and those charged with governance, and the auditor's conclusion about whether uncorrected misstatements are material, individually or in the aggregate, and the basis for that conclusion (AU-C 450.12b and 12c);

r. a summary of internal control weaknesses classified as material weaknesses, other significant deficiencies, and other control deficiencies, and a comparison of material weaknesses the auditor found to the weaknesses reported in management's assessment about the effectiveness of internal control;

s. a summary of instances of the systems' lack of substantial compliance with FFMIA requirements, as well as areas in which there is substantial but not full compliance (for CFO Act agencies);

t. a summary of instances of noncompliance with significant provisions of applicable laws, regulations, contracts, and grant agreements;

u. documentation of overall analytical procedures;

v. documentation of required oral or written communication with management, those charged with governance (see FAM 550.18–.20), and others, including the nature of the significant findings or issues discussed, and when and with whom the discussions took place (AU-C 230.11 and 260.21);

w. a copy or summary of management's communications provided to those charged with governance if, as part of its communication to those charged with governance, management communicated some or all of the matters the auditor is required to communicate, and as a result, the auditor did not communicate these matters at the same level of detail as management (AU-C 260.21);

x. the auditor's conclusion on the adequacy of two-way communication with those charged with governance (see FAM 550.21–.22); and

y. any departures from the applicable "should" procedures and the basis for them, including the audit director's approval and a statement about whether the engagement team provided supporting documentation to the reviewer in a timely manner to allow any issues to be promptly identified and resolved.

Overall Analytical Procedures

.07 The auditor should document the following:

- **Expectations.** The auditor develops these for account/line item balances based on plausible relationships that can be reasonably expected to exist.
- **Data used and sources of data.** These data consist of documentation on the specific financial data used for the current-year amounts and expectations, including the amounts of the financial items; the dates or periods covered by the data; whether the data were audited or unaudited; the persons from whom the data were obtained, if applicable; and the source of the information, such as the general ledger trial balance, prior-year audit documentation, or prior-year financial statements.
- **Parameters for identifying significant fluctuations.** These parameters are left to the auditor's professional judgment based on performance materiality.

- **Explanations for significant fluctuations from expectations and sources of these explanations.** The auditor should determine if explanations obtained are consistent with corroborating evidence in the documentation and should reference to this work.
- **Auditor's conclusions on the results of the procedures.** The auditor should document conclusions reached on the results of overall analytical procedures.

Deficiencies in Internal Control

.08 The auditor should document

- the basis for considering internal control deficiencies as material weaknesses, significant deficiencies, or other control deficiencies;
- any oral communications of control deficiencies that are not included in a written report; and
- procedures performed, such as inquires, to determine the effects of deficiencies in internal control on information in other reports that the entity generated for external distribution or internal decision-making (see FAM 580.84).

Lack of Systems' Substantial Compliance with FFMIA Requirements

.09 The auditor should document the basis for deciding whether systems' noncompliance with FFMIA requirements (for CFO Act agencies) represents a lack of substantial compliance with the three FFMIA requirements for financial management systems (see FAM 580.86–.90 and FAM 701).[16]

Instances of Noncompliance or Suspected Noncompliance

.10 The auditor should include a description of the identified and suspected noncompliance with significant provisions of applicable laws, regulations, contracts, and grant agreements; the results of discussions with management; and the results of any discussions with those charged with governance and other parties inside or outside the entity (AU-C 250.28).

.11 The auditor should document the basis for classifying instances of noncompliance as material noncompliance, other reportable noncompliance, or not reportable. The auditor should also document any oral communications of noncompliance that are not included in a written report. See FAM 580.91 through .99 and FAM 800.

Other Reporting Matters

.12 If the auditor identifies matters arising after the date of the auditor's report, the auditor should refer to AU-C 230.14 and AU-C 560.

.13 The auditor should document procedures performed with respect to any subsequent discovery of facts that could have affected a previously issued audit report on the financial statements (FAM 550.06 and 580.110).

[16]OMB audit guidance contains additional information regarding FFMIA audit requirements.

.14 The auditor should document procedures performed with respect to comparative information (FAM 580.14–.17).

Exit Conference(s)

.15 The auditor should document exit conference(s) with appropriate entity officials. The auditor should also document any exit conference held with those charged with governance, as appropriate.

595 A – Example Unmodified Auditor's Reports

OMB audit guidance requires the auditor to report on internal control but does not require the auditor to express an opinion on the effectiveness of internal control over financial reporting. Example 1 presents a report in which the auditor expresses an opinion on the effectiveness of internal control over financial reporting. Example 2 presents a report in which the auditor has not identified any material weaknesses in internal control and does not express an opinion on internal control effectiveness. In both examples, the audited entity has a fiscal year ending September 30; the auditor's opinion on the financial statements is unmodified; and no reportable noncompliance with selected provisions of applicable laws, regulations, contracts, and grant agreements is identified.

If the auditor is required to report whether an agency's systems comply substantially with the three FFMIA requirements, the example reports should be revised to include this item.

See FAM 595 B for modifications to the auditor's report for a variety of situations.

Example 1 – Unmodified Opinions on Financial Statements and Effectiveness of Internal Control over Financial Reporting, No Significant Deficiencies in Internal Control over Financial Reporting; No Reportable Noncompliance with Applicable Laws, Regulations, Contracts and Grant Agreements

[Auditor's Address (including city and state where the auditor's report is issued)]

Independent Auditor's Report

To **[appropriate addressee]**

In our audits of the fiscal years **[20X2 and 20X1[1]]** financial statements of **[entity[2]]**, we found

- **[entity's]** financial statements as of and for the fiscal years ended **[September 30, 20X2, and 20X1]**, are presented fairly, in all material respects, in accordance with U.S. generally accepted accounting principles;
- **[entity]** maintained, in all material respects, effective internal control over financial reporting as of **[September 30, 20X2]**; and
- no reportable noncompliance for **[fiscal year 20X2]** with provisions of applicable laws, regulations, contracts, and grant agreements we tested.

The following sections discuss in more detail (1) our report on the financial statements and on internal control over financial reporting, which includes **[if applicable, insert "an emphasis-of-matter paragraph related to (include brief description)," "an other-matter paragraph related to (include brief description)," or both]** a section on required supplementary information (RSI)[3] and a section on other information included with the financial statements; [4] (2) our report on compliance with laws, regulations, contracts, and grant agreements; and (3) agency comments **[if applicable, add "and our evaluation" and revise related heading on page 595 A-7 for consistency]**.

Report on the Financial Statements and on Internal Control over Financial Reporting

Opinion on the Financial Statements

In accordance with **[cite audit authority],** we have audited **[entity's]** financial statements. **[Entity's]** financial statements comprise the balance sheets as of **[September 30, 20X2, and 20X1]**; the related statements of net cost **[if included in statement title, insert "of**

[1]Note to auditor: 20X2 denotes the current year, and 20X1 denotes the prior year, under audit.

[2]Note to auditor: This example assumes the acronym of the entity does not include the word "the" in front of it as part of its common usage (example: CFPB). If "the" is part of the common usage of the acronym (example: the FBI), apply throughout the example.

[3]The RSI consists of **[insert description of the RSI, such as "Management's Discussion and Analysis" and the "Combined Statement of Budgetary Resources"]**, which are included with the financial statements.

[4]Other information consists of information included with the financial statements, other than the RSI **[if applicable]** and the auditor's report.

operations"], changes in net position, and budgetary resources for the fiscal years then ended;[5] and the related notes to the financial statements. In our opinion, **[entity's]** financial statements present fairly, in all material respects, **[entity's]** financial position as of **[September 30, 20X2, and 20X1]**, and its net cost of operations, changes in net position, and budgetary resources for the fiscal years then ended in accordance with U.S. generally accepted accounting principles.

Opinion on Internal Control over Financial Reporting

We also have audited **[entity's]** internal control over financial reporting as of **[September 30, 20X2]**, based on criteria established under 31 U.S.C. § 3512(c), (d), commonly known as the Federal Managers' Financial Integrity Act of 1982 (FMFIA). In our opinion, **[entity]** maintained, in all material respects, effective internal control over financial reporting as of **[September 30, 20X2]**, based on criteria established under FMFIA.

[If applicable] During our **[20X2]** audit, we identified deficiencies in **[entity's]** internal control over financial reporting that we do not consider to be material weaknesses or significant deficiencies.[6] Nonetheless, these deficiencies warrant **[entity]** management's attention. We have communicated these matters to **[entity]** management and, where appropriate, will report on them separately.

Basis for Opinions

We conducted our audits in accordance with U.S. generally accepted government auditing standards. Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audits of the Financial Statements and Internal Control over Financial Reporting section of our report. We are required to be independent of **[entity]** and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audits. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

[Note: If applicable, insert emphasis-of-matter paragraph(s), other-matter paragraph(s), or both in accordance with AU-C 706. Include related heading(s).]

Responsibilities of Management for the Financial Statements and Internal Control over Financial Reporting

Management is responsible for

- the preparation and fair presentation of the financial statements in accordance with U.S. generally accepted accounting principles;
- preparing, measuring, and presenting the RSI in accordance with U.S. generally accepted accounting principles;

[5]Note to auditor: The names of the financial statements should be modified as appropriate.

[6]A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

- preparing and presenting other information included in **[entity's] [insert name of annual report, e.g., agency financial report]**, and ensuring the consistency of that information with the audited financial statements and the RSI;
- designing, implementing, and maintaining effective internal control over financial reporting relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error;
- assessing the effectiveness of internal control over financial reporting based on the criteria established under FMFIA; and
- its assessment about the effectiveness of internal control over financial reporting as of **[September 30, 20X2]**, included in the accompanying Management's Report on Internal Control over[7] Financial Reporting **[or other title of management's report]** in appendix I.

[For entities that conform to FASB standards] In preparing the financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about **[entity's]** ability to continue as a going concern for a reasonable period of time.

Auditor's Responsibilities for the Audits of the Financial Statements and Internal Control over Financial Reporting

Our objectives are to (1) obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and whether effective internal control over financial reporting was maintained in all material respects, and (2) issue an auditor's report that includes our opinions.

Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit of the financial statements or an audit of internal control over financial reporting conducted in accordance with U.S. generally accepted government auditing standards will always detect a material misstatement or a material weakness when it exists.[8] The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements, including omissions, are considered to be material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements.[9]

In performing an audit of financial statements and an audit of internal control over financial reporting in accordance with U.S. generally accepted government auditing standards, we:

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[7]Note to auditor: GAO does not capitalize the "o" in "over" in the phrase "internal control over financial reporting" when used in a heading or title. However, when referring to the title of management's report included with the auditor's report, the wording and capitalization should be consistent with management's presentation.

[8]**[Insert this footnote if this is the first time the term "material weakness" is used in the auditor's report.]** A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis.

[9]Note to auditor: Statement of Federal Financial Accounting Concepts (SFFAC) 1 issued by FASAB provides a slightly different definition of materiality. Since SFFACs are nonauthoritative, and in SFFAC 1, the board recognizes differences from the audit definition, the FAM is based on the definition provided in AU-C 200.07.

- Exercise professional judgment and maintain professional skepticism throughout the audits.
- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.
- Obtain an understanding of internal control relevant to our audit of the financial statements in order to design audit procedures that are appropriate in the circumstances.
- Obtain an understanding of internal control relevant to our audit of internal control over financial reporting, assess the risks that a material weakness exists, and test and evaluate the design and operating effectiveness of internal control over financial reporting based on the assessed risk. Our audit of internal control also considered **[entity's]** process for evaluating and reporting on internal control over financial reporting based on criteria established under FMFIA. We did not evaluate all internal controls relevant to operating objectives as broadly established under FMFIA, such as those controls relevant to preparing performance information and ensuring efficient operations. We limited our internal control testing to testing controls over financial reporting. Our internal control testing was for the purpose of expressing an opinion on whether effective internal control over financial reporting was maintained, in all material respects. Consequently, our audit may not identify all deficiencies in internal control over financial reporting that are less severe than a material weakness.
- Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the financial statements.
- Perform other procedures we consider necessary in the circumstances.
- **[For entities that conform to FASB standards]** Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about **[entity's]** ability to continue as a going concern for a reasonable period of time.

We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control–related matters that we identified during the financial statement audit.

Definition and Inherent Limitations of Internal Control over Financial Reporting

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel. The objectives of internal control over financial reporting are to provide reasonable assurance that

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

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct, misstatements due to fraud or error. We also caution that projecting any evaluation of effectiveness to future periods is subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Required Supplementary Information

U.S. generally accepted accounting principles issued by the Federal Accounting Standards Advisory Board (FASAB) require that the RSI be presented to supplement the financial statements. Such information is the responsibility of management and, although not a part of the financial statements, is required by FASAB, which considers it to be an essential part of financial reporting for placing the financial statements in appropriate operational, economic, or historical context.

We have applied certain limited procedures to the RSI in accordance with U.S. generally accepted government auditing standards. These procedures consisted of (1) inquiring of management about the methods used to prepare the RSI and (2) comparing the RSI for consistency with management's responses to our inquiries, the financial statements, and other knowledge we obtained during the audit of the financial statements, in order to report omissions or material departures from FASAB guidelines, if any, identified by these limited procedures. We did not audit and we do not express an opinion or provide any assurance on the RSI because the limited procedures we applied do not provide sufficient evidence to express an opinion or provide any assurance.[10]

Other Information

[Entity's] other information contains a wide range of information, some of which is not directly related to the financial statements. This information is presented for purposes of additional analysis and is not a required part of the financial statements or the RSI. Management is responsible for the other information included in **[entity's] [insert name of annual report, e.g., agency financial report]**. The other information comprises the following sections: **[list section titles of other information included in the annual report]**. Other information does not include the financial statements and our auditor's report thereon. Our opinion on the financial statements does not cover the other information, and we do not express an opinion or any form of assurance thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and consider whether a material inconsistency exists between the other information and the financial statements, or the other information otherwise appears to be materially misstated. If, based on the work performed, we conclude that an uncorrected material misstatement of the other information exists, we are required to describe it in our report.[11]

Report on Compliance with Laws, Regulations, Contracts, and Grant Agreements

In connection with our audits of **[entity's]** financial statements, we tested compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements consistent with our auditor's responsibilities discussed below.

Results of Our Tests for Compliance with Laws, Regulations, Contracts, and Grant Agreements

Our tests for compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements disclosed no instances of noncompliance for **[fiscal year 20X2]** that would be reportable under U.S. generally accepted government auditing standards. However, the

[10]Note to auditor: Refer to AU-C 730.08d through .08g; .09; and .A3, illustrations 2 through 6, if (1) the auditor is unable to complete the procedures described in this paragraph, (2) some or all of the RSI is omitted, (3) the measurement or presentation of the RSI departs materially from prescribed guidelines, or (4) the auditor has unresolved doubts about whether the RSI is measured or presented in accordance with prescribed guidelines.

[11]Note to auditor: Refer to AU-C 720.24f; .25; and .A62, illustration 2, if the auditor has concluded that an uncorrected material misstatement of the other information exists.

objective of our tests was not to provide an opinion on compliance with laws, regulations, contracts, and grant agreements applicable to **[entity]**. Accordingly, we do not express such an opinion.

Basis for Results of Our Tests for Compliance with Laws, Regulations, Contracts, and Grant Agreements

We performed our tests of compliance in accordance with U.S. generally accepted government auditing standards.

Responsibilities of Management for Compliance with Laws, Regulations, Contracts, and Grant Agreements

[Entity] management is responsible for complying with laws, regulations, contracts, and grant agreements applicable to **[entity]**.

Auditor's Responsibilities for Tests of Compliance with Laws, Regulations, Contracts, and Grant Agreements

Our responsibility is to test compliance with selected provisions of laws, regulations, contracts, and grant agreements applicable to **[entity]** that have a direct effect on the determination of material amounts and disclosures in **[entity's]** financial statements, and to perform certain other limited procedures. Accordingly, we did not test compliance with all provisions of laws, regulations, contracts, and grant agreements applicable to **[entity]**. We caution that noncompliance may occur and not be detected by these tests.

Intended Purpose of Report on Compliance with Laws, Regulations, Contracts, and Grant Agreements

The purpose of this report is solely to describe the scope of our testing of compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements, and the results of that testing, and not to provide an opinion on compliance. This report is an integral part of an audit performed in accordance with U.S. generally accepted government auditing standards in considering compliance. Accordingly, this report on compliance with laws, regulations, contracts, and grant agreements is not suitable for any other purpose.

Agency Comments [If applicable, add "and Our Evaluation." Heading should be consistent with related wording on page 595 A-2.]

In commenting on a draft of this report, **[entity[12]]** ……The complete text of **[entity's]** response is reprinted in appendix II.

[Signature]

[Title]

[Date of auditor's report]

[12]Note to auditor: For GAO reports, only the entity name is cited in this section if the entity provides written comments. Do not include the name or title of the commenting official. If the entity provides email or oral comments, the title of the commenting official is included. See Words@Work on the GAO intranet.

Example 2 – Unmodified Opinion on Financial Statements, No Opinion on Effectiveness of Internal Control over Financial Reporting (No Material Weakness or Significant Deficiency Identified), No Reportable Noncompliance with Applicable Laws, Regulations, Contracts, and Grant Agreements

[Auditor's Address (including city and state where the auditor's report is issued)]

Independent Auditor's Report

To **[appropriate addressee]**

In our audits of the fiscal years **[20X2 and 20X1[13]]** financial statements of **[entity[14]]**, we found

- **[entity's]** financial statements as of and for the fiscal years ended **[September 30, 20X2, and 20X1]**, are presented fairly, in all material respects, in accordance with U.S. generally accepted accounting principles;
- no material weaknesses in internal control over financial reporting based on the limited procedures we performed;[15] and
- no reportable noncompliance for **[fiscal year 20X2]** with provisions of applicable laws, regulations, contracts, and grant agreements we tested.

The following sections discuss in more detail (1) our report on the financial statements, which includes **[if applicable, insert "an emphasis-of-matter paragraph related to (include brief description)," "an other-matter paragraph related to (include brief description)," or both]** a section on required supplementary information (RSI)[16] and a section on other information included with the financial statements;[17] (2) our report on internal control over financial reporting; (3) our report on compliance with laws, regulations, contracts, and grant agreements; and (4) agency comments **[if applicable, add "and our evaluation" and revise related heading on page 595 A-14 for consistency]**.

[13]Note to auditor: 20X2 denotes the current year, and 20X1 denotes the prior year, under audit.

[14]Note to auditor: This example assumes the acronym of the entity does not include the word "the" in front of it as part of its common usage (example: CFPB). If "the" is part of the common usage of the acronym (example: the FBI), apply throughout the example.

[15]A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis.

[16]The RSI consists of **[insert description of the RSI, such as "Management's Discussion and Analysis" and the "Combined Statement of Budgetary Resources"]**, which are included with the financial statements.

[17]Other information consists of information included with the financial statements, other than the RSI **[if applicable]** and the auditor's report.

Report on the Financial Statements

Opinion

In accordance with [**cite audit authority**], we have audited **[entity's]** financial statements. **[Entity's]** financial statements comprise the balance sheets as of **[September 30, 20X2, and 20X1]**; the related statements of net cost **[if included in the statement title, insert "of operations"]**, changes in net position, and budgetary resources for the fiscal years then ended;[18] and the related notes to the financial statements. In our opinion, **[entity's]** financial statements present fairly, in all material respects, **[entity's]** financial position as of **[September 30, 20X2, and 20X1]**, and its net cost of operations, changes in net position, and budgetary resources for the fiscal years then ended in accordance with U.S. generally accepted accounting principles.

Basis for Opinion

We conducted our audits in accordance with U.S. generally accepted government auditing standards. Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are required to be independent of **[entity]** and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audit. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

[Note: If applicable, insert emphasis-of-matter paragraph(s), other-matter paragraph(s), or both in accordance with AU-C 706. Include related heading(s).]

Responsibilities of Management for the Financial Statements

Management is responsible for

- the preparation and fair presentation of the financial statements in accordance with U.S. generally accepted accounting principles;
- preparing, measuring, and presenting the RSI in accordance with U.S. generally accepted accounting principles;
- preparing and presenting other information included in **[entity's] [insert name of annual report, e.g., agency financial report]**, and ensuring the consistency of that information with the audited financial statements and the RSI; and
- designing, implementing, and maintaining effective internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

[For entities that conform to FASB standards] In preparing the financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about **[entity's]** ability to continue as a going concern for a reasonable period of time.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to (1) obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and (2) issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit of the financial

[18]Note to auditor: The names of the financial statements should be modified as appropriate.

statements conducted in accordance with U.S. generally accepted government auditing standards will always detect a material misstatement or a material weakness when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements, including omissions, are considered to be material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements.[19]

In performing an audit in accordance with U.S. generally accepted government auditing standards, we:

- Exercise professional judgment and maintain professional skepticism throughout the audit.
- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.
- Obtain an understanding of internal control relevant to our audit of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of **[entity's]** internal control over financial reporting. Accordingly, no such opinion is expressed.
- Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the financial statements.
- Perform other procedures we consider necessary in the circumstances.
- **[For entities that conform to FASB standards]** Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about **[entity's]** ability to continue as a going concern for a reasonable period of time.

We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control–related matters that we identified during the financial statement audit.

Required Supplementary Information

U.S. generally accepted accounting principles issued by the Federal Accounting Standards Advisory Board (FASAB) require that the RSI be presented to supplement the financial statements. Such information is the responsibility of management and, although not a part of the financial statements, is required by FASAB, which considers it to be an essential part of financial reporting for placing the financial statements in appropriate operational, economic, or historical context.

We have applied certain limited procedures to the RSI in accordance with U.S. generally accepted government auditing standards. These procedures consisted of (1) inquiring of management about the methods used to prepare the RSI and (2) comparing the RSI for consistency with management's responses to our inquiries, the financial statements, and other knowledge we obtained during the audit of the financial statements, in order to report omissions or material departures from FASAB guidelines, if any, identified by these limited procedures. We

[19]Note to auditor: Statement of Federal Financial Accounting Concepts (SFFAC) 1 issued by FASAB provides a slightly different definition of materiality. Since SFFACs are nonauthoritative, and in SFFAC 1, the board recognizes differences from the audit definition, the FAM is based on the definition provided in AU-C 200.07.

did not audit and we do not express an opinion or provide any assurance on the RSI because the limited procedures we applied do not provide sufficient evidence to express an opinion or provide any assurance.[20]

Other Information

[Entity's] other information contains a wide range of information, some of which is not directly related to the financial statements. This information is presented for purposes of additional analysis and is not a required part of the financial statements or the RSI. Management is responsible for the other information included in **[entity's] [insert name of annual report, e.g., agency financial report]**. The other information comprises the following sections: **[list section titles of other information included in the annual report]**. Other information does not include the financial statements and our auditor's report thereon. Our opinion on the financial statements does not cover the other information, and we do not express an opinion or any form of assurance thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and consider whether a material inconsistency exists between the other information and the financial statements, or the other information otherwise appears to be materially misstated. If, based on the work performed, we conclude that an uncorrected material misstatement of the other information exists, we are required to describe it in our report.[21]

Report on Internal Control over Financial Reporting

In connection with our audits of **[entity's]** financial statements, we considered **[entity's]** internal control over financial reporting, consistent with our auditor's responsibilities discussed below.

Results of Our Consideration of Internal Control over Financial Reporting

Our consideration of internal control was for the limited purpose described below, and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies[22] or to express an opinion on the effectiveness of **[entity's]** internal control over financial reporting. Given these limitations, during our **[20X2]** audit, we did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses. However, material weaknesses or significant deficiencies may exist that have not been identified.

[If applicable] During our **[20X2]** audit, we identified deficiencies in **[entity's]** internal control over financial reporting that we do not consider to be material weaknesses or significant deficiencies. Nonetheless, these deficiencies warrant **[entity]** management's attention. We have communicated these matters to **[entity]** management and, where appropriate, will report on them separately.

Basis for Results of Our Consideration of Internal Control over Financial Reporting

[20]Note to auditor: Refer to AU-C 730.08d through .08g; .09; and .A3, illustrations 2 through 6, if (1) the auditor is unable to complete the procedures described in this paragraph, (2) some or all of the RSI is omitted, (3) the measurement or presentation of the RSI departs materially from prescribed guidelines, or (4) the auditor has unresolved doubts about whether the RSI is measured or presented in accordance with prescribed guidelines.

[21]Note to auditor: Refer to AU-C 720.24f; .25; and .A62, illustration 2, if the auditor has concluded that an uncorrected material misstatement of the other information exists.

[22]A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

We performed our procedures related to **[entity's]** internal control over financial reporting in accordance with U.S. generally accepted government auditing standards and Office of Management and Budget audit guidance.[23]

Responsibilities of Management for Internal Control over Financial Reporting

[Entity] management is responsible for designing, implementing, and maintaining effective internal control over financial reporting relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibilities for Internal Control over Financial Reporting

In planning and performing our audit of **[entity's]** financial statements as of and for the fiscal year ended **[September 30, 20X2]**, in accordance with U.S. generally accepted government auditing standards, we considered **[entity's]** internal control relevant to the financial statement audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of **[entity's]** internal control over financial reporting. Accordingly, we do not express an opinion on **[entity's]** internal control over financial reporting. We are required to report all deficiencies that are considered to be significant deficiencies or material weaknesses. We did not consider all internal controls relevant to operating objectives, such as those controls relevant to preparing performance information and ensuring efficient operations.

Definition and Inherent Limitations of Internal Control over Financial Reporting

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel. The objectives of internal control over financial reporting are to provide reasonable assurance that

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

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct, misstatements due to fraud or error.

Intended Purpose of Report on Internal Control over Financial Reporting

The purpose of this report is solely to describe the scope of our consideration of **[entity's]** internal control over financial reporting and the results of our procedures, and not to provide an opinion on the effectiveness of **[entity's]** internal control over financial reporting. This report is an integral part of an audit performed in accordance with U.S. generally accepted government auditing standards in considering internal control over financial reporting. Accordingly, this report on internal control over financial reporting is not suitable for any other purpose.

Report on Compliance with Laws, Regulations, Contracts, and Grant Agreements

[23]Office of Management and Budget (OMB) Bulletin No. 24-01, *Audit Requirements for Federal Financial Statements*, issued on October 19, 2023. According to the guidance, for those controls that have been suitably designed and implemented, the auditor should perform sufficient tests of such controls to conclude on whether the controls are operating effectively (i.e., sufficient tests of controls to support a low level of assessed control risk). OMB audit guidance does not require the auditor to express an opinion on the effectiveness of internal control.

In connection with our audits of **[entity's]** financial statements, we tested compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements consistent with our auditor's responsibilities discussed below.

Results of Our Tests for Compliance with Laws, Regulations, Contracts, and Grant Agreements

Our tests for compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements disclosed no instances of noncompliance for **[fiscal year 20X2]** that would be reportable under U.S. generally accepted government auditing standards. However, the objective of our tests was not to provide an opinion on compliance with laws, regulations, contracts, and grant agreements applicable to **[entity]**. Accordingly, we do not express such an opinion.

Basis for Results of Our Tests for Compliance with Laws, Regulations, Contracts, and Grant Agreements

We performed our tests of compliance in accordance with U.S. generally accepted government auditing standards.

Responsibilities of Management for Compliance with Laws, Regulations, Contracts, and Grant Agreements

[Entity] management is responsible for complying with laws, regulations, contracts, and grant agreements applicable to **[entity]**.

Auditor's Responsibilities for Tests of Compliance with Laws, Regulations, Contracts, and Grant Agreements

Our responsibility is to test compliance with selected provisions of laws, regulations, contracts, and grant agreements applicable to **[entity]** that have a direct effect on the determination of material amounts and disclosures in **[entity's]** financial statements, and to perform certain other limited procedures. Accordingly, we did not test compliance with all provisions of laws, regulations, contracts, and grant agreements applicable to **[entity]**. We caution that noncompliance may occur and not be detected by these tests.

Intended Purpose of Report on Compliance with Laws, Regulations, Contracts, and Grant Agreements

The purpose of this report is solely to describe the scope of our testing of compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements, and the results of that testing, and not to provide an opinion on compliance. This report is an integral part of an audit performed in accordance with U.S. generally accepted government auditing standards in considering compliance. Accordingly, this report on compliance with laws, regulations, contracts, and grant agreements is not suitable for any other purpose.

Agency Comments [if applicable, add "and Our Evaluation." Heading should be consistent with related wording on page 595 A-8.]

In commenting on a draft of this report, **[entity[24]]** ……The complete text of **[entity's]** response is reprinted in appendix II.

[Signature]

[Title]

[Date of auditor's report]

[24]Note to auditor: For GAO reports, only the entity name is cited in this section if the entity provides written comments. Do not include the name or title of the commenting official. If the entity provides email or oral comments, the title of the commenting official is included. See Words@Work on the GAO intranet.

595 B – Example of Reporting Material Weakness or Significant Deficiency on Internal Control over Financial Reporting

Example 1 presents a report in which the auditor expresses an adverse opinion on the effectiveness of internal control over financial reporting and a material weakness exists.

Example 2 presents a report in which the auditor expresses an unmodified opinion on the effectiveness of internal control over financial reporting and a significant deficiency exists.

In both examples, the audited entity has a fiscal year ending September 30; the auditor's opinion on the financial statements is unmodified; and no reportable noncompliance with selected provisions of applicable laws, regulations, contracts, and grant agreements is identified.

If the auditor is required to report whether an agency's systems comply substantially with the three FFMIA requirements, the example reports should be revised to include this item.

Example 1 – Unmodified Opinion on Financial Statements; Adverse Opinion on Internal Control over Financial Reporting; No Reportable Noncompliance with Applicable Laws, Regulations, Contracts, and Grant Agreements

[Auditor's Address (including city and state where the auditor's report is issued)]

Independent Auditor's Report

To **[appropriate addressee]**

In our audits of the fiscal years **[20X2 and 20X1[1]]** financial statements of **[entity[2]]**, we found

- **[entity's]** financial statements as of and for the fiscal years ended **[September 30, 20X2, and 20X1]**, are presented fairly, in all material respects, in accordance with U.S. generally accepted accounting principles;
- **[entity's]** internal control over financial reporting was not effective as of **[September 30, 20X2]**; and
- no reportable noncompliance for **[fiscal year 20X2]** with provisions of applicable laws, regulations, contracts, and grant agreements we tested.

The following sections discuss in more detail (1) our report on the financial statements and on internal control over financial reporting, which includes **[if applicable, insert "an emphasis-of-matter paragraph related to (include brief description)," "an other-matter paragraph related to (include brief description)," or both]** a section on required supplementary information (RSI)[3] and a section on other information included with the financial statements;[4] (2) our report on compliance with laws, regulations, contracts, and grant agreements; and (3) agency comments **[if applicable, add "and our evaluation" and revise related heading on page 595 B-8 for consistency]**.

Report on the Financial Statements and on Internal Control over Financial Reporting

Opinion on the Financial Statements

In accordance with **[cite audit authority],** we have audited **[entity's]** financial statements. **[Entity's]** financial statements comprise the balance sheets as of **[September 30, 20X2, and**

[1]Note to auditor: 20X2 denotes the current year, and 20X1 denotes the prior year, under audit.

[2]Note to auditor: This example assumes the acronym of the entity does not include the word "the" in front of it as part of its common usage (example: CFPB). If "the" is part of the common usage of the acronym (example: the FBI), apply throughout the example.

[3]The RSI consists of **[insert description of the RSI, such as "Management's Discussion and Analysis" and the "Combined Statement of Budgetary Resources"]**, which are included with the financial statements.

[4]Other information consists of information included with the financial statements, other than the RSI **[if applicable]** and the auditor's report.

20X1]; the related statements of net cost **[if included in statement title, insert "of operations"]**, changes in net position, and budgetary resources for the fiscal years then ended;[5] and the related notes to the financial statements. In our opinion, **[entity's]** financial statements present fairly, in all material respects, **[entity's]** financial position as of **[September 30, 20X2, and 20X1]**, and its net cost of operations, changes in net position, and budgetary resources for the fiscal years then ended in accordance with U.S. generally accepted accounting principles.

However, misstatements may nevertheless occur in unaudited financial information reported internally or externally by **[entity]** as a result of the internal control deficiencies described in this report.

Adverse Opinion on Internal Control over Financial Reporting

We also have audited **[entity's]** internal control over financial reporting as of **[September 30, 20X2]**, based on criteria established under 31 U.S.C. § 3512(c), (d), commonly known as the Federal Managers' Financial Integrity Act of 1982 (FMFIA). In our opinion, because of a material weakness in internal control over **[briefly name the deficiency]**, **[entity]** did not maintain, in all material respects, effective internal control over financial reporting as of **[September 30, 20X2]**, based on criteria established under FMFIA.[6]

[Customize as appropriate] Although **[entity]** had a material weakness in internal control over **[briefly name the deficiency], [which existed in prior years, (if applicable)] [entity]** made any necessary adjustments to its records and was therefore able to prepare financial statements that were fairly presented in all material respects for fiscal year **[20X2].** This material weakness, which is discussed in more detail in the Basis for Adverse Opinion on Internal Control over Financial Reporting section, is also disclosed by **[entity]** in its fiscal year **[20X2]** (1) FMFIA assurance statement and (2) Management's Report on Internal Control over Financial Reporting. We considered this material weakness in determining the nature, timing, and extent of our audit procedures on **[entity's]** fiscal year **[20X2]** financial statements.

[If applicable] In addition to the material weakness in internal control over **[insert description of material weakness from above]**, we also identified other deficiencies in **[entity's]** internal control over financial reporting that we do not consider to be material weaknesses or significant deficiencies.[7] Nonetheless, these deficiencies warrant **[entity]** management's attention. We have communicated these matters to **[entity]** management and, where appropriate, will report on them separately.[8]

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[5]Note to auditor: The names of the financial statements should be modified as appropriate.

[6]A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis.

[7]A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

[8]Note to auditor: If applicable, consider adding the following sentence to the beginning of the paragraph "We will be reporting additional details concerning this material weakness separately to **[entity]** management, along with recommendations for corrective actions."

Basis for Opinion on the Financial Statements

We conducted our audits in accordance with U.S. generally accepted government auditing standards. Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audits of the Financial Statements and Internal Control over Financial Reporting section of our report. We are required to be independent of **[entity]** and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audits. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion on the financial statements.

Basis for Adverse Opinion on Internal Control over Financial Reporting

We identified the following material weakness in our audits of the fiscal years **[20X2 and 20X1]** financial statements of **[entity]**.

Material Weakness in Internal Control over [briefly name the deficiency]

[Describe material weakness, including any progress or changes in the internal control deficiencies identified if they were previously reported.]

We conducted our audits in accordance with U.S. generally accepted government auditing standards. Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audits of the Financial Statements and Internal Control over Financial Reporting section of our report. We are required to be independent of **[entity]** and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audits. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our adverse audit opinion on internal control over financial reporting.

[Note: If applicable, insert emphasis-of-matter paragraph(s), other-matter paragraph(s), or both in accordance with AU-C 706. Include related heading(s).]

Responsibilities of Management for the Financial Statements and Internal Control over Financial Reporting

Management is responsible for

- the preparation and fair presentation of the financial statements in accordance with U.S. generally accepted accounting principles;
- preparing, measuring, and presenting the RSI in accordance with U.S. generally accepted accounting principles;
- preparing and presenting other information included in **[entity's] [insert name of annual report, e.g., agency financial report]**, and ensuring the consistency of that information with the audited financial statements and the RSI;
- designing, implementing, and maintaining effective internal control over financial reporting relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error;
- assessing the effectiveness of internal control over financial reporting based on the criteria established under FMFIA; and

- its assessment about the effectiveness of internal control over financial reporting as of **[September 30, 20X2]**, included in the accompanying Management's Report on Internal Control over[9] Financial Reporting **[or other title of management's report]** in appendix I.

[For entities that conform to FASB standards] In preparing the financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about **[entity's]** ability to continue as a going concern for a reasonable period of time.

Auditor's Responsibilities for the Audits of the Financial Statements and Internal Control over Financial Reporting

Our objectives are to (1) obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and whether effective internal control over financial reporting was maintained in all material respects, and (2) issue an auditor's report that includes our opinions. Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit of the financial statements or an audit of internal control over financial reporting conducted in accordance with U.S. generally accepted government auditing standards will always detect a material misstatement or a material weakness when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements, including omissions, are considered to be material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements.[10]

In performing an audit of financial statements and an audit of internal control over financial reporting in accordance with U.S. generally accepted government auditing standards, we:

- Exercise professional judgment and maintain professional skepticism throughout the audits.
- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.
- Obtain an understanding of internal control relevant to our audit of the financial statements in order to design audit procedures that are appropriate in the circumstances.
- Obtain an understanding of internal control relevant to our audit of internal control over financial reporting, assess the risks that a material weakness exists, and test and evaluate the design and operating effectiveness of internal control over financial reporting based on the assessed risk. Our audit of internal control also considered **[entity's]** process for evaluating and reporting on internal control over financial reporting based on criteria established under FMFIA. We did not evaluate all internal controls relevant to operating objectives as broadly established under FMFIA, such as those controls relevant to preparing

[9]Note to auditor: GAO does not capitalize the "o" in "over" in the phrase "internal control over financial reporting" when used in a heading or title. However, when referring to the title of management's report included with the auditor's report, the wording and capitalization should be consistent with management's presentation.

[10]Note to auditor: Statement of Federal Financial Accounting Concepts (SFFAC) 1 issued by FASAB provides a slightly different definition of materiality. Since SFFACs are nonauthoritative, and in SFFAC 1, the board recognizes differences from the audit definition, the FAM is based on the definition provided in AU-C 200.07.

performance information and ensuring efficient operations. We limited our internal control testing to testing controls over financial reporting. Our internal control testing was for the purpose of expressing an opinion on whether effective internal control over financial reporting was maintained, in all material respects. Consequently, our audit may not identify all deficiencies in internal control over financial reporting that are less severe than a material weakness.

- Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the financial statements.
- Perform other procedures we consider necessary in the circumstances.
- **[For entities that conform to FASB standards]** Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about **[entity's]** ability to continue as a going concern for a reasonable period of time.

We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control–related matters that we identified during the financial statement audit.

Definition and Inherent Limitations of Internal Control over Financial Reporting

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel. The objectives of internal control over financial reporting are to provide reasonable assurance that

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

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct, misstatements due to fraud or error. We also caution that projecting any evaluation of effectiveness to future periods is subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Required Supplementary Information

U.S. generally accepted accounting principles issued by the Federal Accounting Standards Advisory Board (FASAB) require that the RSI be presented to supplement the financial statements. Such information is the responsibility of management and, although not a part of the financial statements, is required by FASAB, which considers it to be an essential part of financial reporting for placing the financial statements in appropriate operational, economic, or historical context.

We have applied certain limited procedures to the RSI in accordance with U.S. generally accepted government auditing standards. These procedures consisted of (1) inquiring of management about the methods used to prepare the RSI and (2) comparing the RSI for consistency with management's responses to our inquiries, the financial statements, and other knowledge we obtained during the audit of the financial statements, in order to report omissions or material departures from FASAB guidelines, if any, identified by these limited procedures. We

did not audit and we do not express an opinion or provide any assurance on the RSI because the limited procedures we applied do not provide sufficient evidence to express an opinion or provide any assurance.[11]

Other Information

[Entity's] other information contains a wide range of information, some of which is not directly related to the financial statements. This information is presented for purposes of additional analysis and is not a required part of the financial statements or the RSI. Management is responsible for the other information included in **[entity's] [insert name of annual report, e.g., agency financial report]**. The other information comprises the following sections: **[list section titles of other information included in the annual report]**. Other information does not include the financial statements and our auditor's report thereon. Our opinion on the financial statements does not cover the other information, and we do not express an opinion or any form of assurance thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and consider whether a material inconsistency exists between the other information and the financial statements, or the other information otherwise appears to be materially misstated. If, based on the work performed, we conclude that an uncorrected material misstatement of the other information exists, we are required to describe it in our report.[12]

Report on Compliance with Laws, Regulations, Contracts, and Grant Agreements

In connection with our audits of **[entity's]** financial statements, we tested compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements consistent with our auditor's responsibilities discussed below.

Results of Our Tests for Compliance with Laws, Regulations, Contracts, and Grant Agreements

Our tests for compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements disclosed no instances of noncompliance for **[fiscal year 20X2]** that would be reportable under U.S. generally accepted government auditing standards. However, the objective of our tests was not to provide an opinion on compliance with laws, regulations, contracts, and grant agreements applicable to **[entity]**. Accordingly, we do not express such an opinion.

Basis for Results of Our Tests for Compliance with Laws, Regulations, Contracts, and Grant Agreements

We performed our tests of compliance in accordance with U.S. generally accepted government auditing standards.

Responsibilities of Management for Compliance with Laws, Regulations, Contracts, and Grant Agreements

[Entity] management is responsible for complying with laws, regulations, contracts, and grant agreements applicable to **[entity]**.

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[11]Note to auditor: Refer to AU-C 730.08d through .08g; .09; and .A3, illustrations 2 through 6, if (1) the auditor is unable to complete the procedures described in this paragraph, (2) some or all of the RSI is omitted, (3) the measurement or presentation of the RSI departs materially from the prescribed guidelines, or (4) the auditor has unresolved doubts about whether the RSI is measured or presented in accordance with prescribed guidelines.

[12]Note to auditor: Refer to AU-C 720.24f; .25; and .A62, illustration 2, if the auditor has concluded that an uncorrected material misstatement of the other information exists.

Auditor's Responsibilities for Tests of Compliance with Laws, Regulations, Contracts, and Grant Agreements

Our responsibility is to test compliance with selected provisions of laws, regulations, contracts, and grant agreements applicable to **[entity]** that have a direct effect on the determination of material amounts and disclosures in **[entity's]** financial statements, and to perform certain other limited procedures. Accordingly, we did not test compliance with all provisions of laws, regulations, contracts, and grant agreements applicable to **[entity]**. We caution that noncompliance may occur and not be detected by these tests.

Intended Purpose of Report on Compliance with Laws, Regulations, Contracts, and Grant Agreements

The purpose of this report is solely to describe the scope of our testing of compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements, and the results of that testing, and not to provide an opinion on compliance. This report is an integral part of an audit performed in accordance with U.S. generally accepted government auditing standards in considering compliance. Accordingly, this report on compliance with laws, regulations, contracts, and grant agreements is not suitable for any other purpose.

Agency Comments [If applicable, add "and Our Evaluation." Heading should be consistent with related wording on page 595 B-2.]

In commenting on a draft of this report, **[entity[13]]** ……The complete text of **[entity's]** response is reprinted in appendix II.

[Signature]

[Title]

[Date of auditor's report]

[13]Note to auditor: For GAO reports, only the entity name is cited in this section if the entity provides written comments. Do not include the name or title of the commenting official. If the entity provides email or oral comments, the title of the commenting official is included. See Words@Work on the GAO intranet.

Example 2 – Unmodified Opinion on Financial Statements; Unmodified Opinion on Internal Control over Financial Reporting, but Significant Deficiency Exists (No Material Weaknesses); No Reportable Noncompliance with Applicable Laws, Regulations, Contracts, and Grant Agreements

[Auditor's Address (including city and state where the auditor's report is issued)]

Independent Auditor's Report

To **[appropriate addressee]**

In our audits of the fiscal years **[20X2 and 20X1[14]]** financial statements of **[entity[15]]**, we found

- **[entity's]** financial statements as of and for the fiscal years ended **[September 30, 20X2, and 20X1]**, are presented fairly, in all material respects, in accordance with U.S. generally accepted accounting principles;
- although internal controls could be improved, **[entity]** maintained, in all material respects, effective internal control over financial reporting as of **[September 30, 20X2]**; and
- no reportable noncompliance for **[fiscal year 20X2]** with provisions of applicable laws, regulations, contracts, and grant agreements we tested.

The following sections discuss in more detail (1) our report on the financial statements and on internal control over financial reporting, which includes **[if applicable insert "an emphasis-of-matter paragraph related to (include brief description)," "an other-matter paragraph related to (include brief description)," or both]** a section on required supplementary information (RSI)[16] and a section on other information included with the financial statements;[17] (2) our report on compliance with laws, regulations, contracts, and grant agreements; and (3) agency comments **[if applicable, add "and our evaluation" and revise related heading on page 595 B-15 for consistency]**.

Report on the Financial Statements and on Internal Control over Financial Reporting

Opinion on the Financial Statements

In accordance with **[cite audit authority],** we have audited **[entity's]** financial statements. **[Entity's]** financial statements comprise the balance sheets as of **[September 30, 20X2, and**

[14]Note to auditor: 20X2 denotes the current year, and 20X1 denotes the prior year, under audit.

[15]Note to auditor: This example assumes the acronym of the entity does not include the word "the" in front of it as part of its common usage (example: CFPB). If "the" is part of the common usage of the acronym (example: the FBI), apply throughout the example.

[16]The RSI consists of **[insert description of the RSI, such as "Management's Discussion and Analysis" and the "Combined Statement of Budgetary Resources"]**, which are included with the financial statements.

[17]Other information consists of information included with the financial statements, other than the RSI **[if applicable]** and the auditor's report.

20X1]; the related statements of net cost **[if included in statement title, insert "of operations"]**, changes in net position, and budgetary resources for the fiscal years then ended;[18] and the related notes to the financial statements. In our opinion, **[entity's]** financial statements present fairly, in all material respects, **[entity's]** financial position as of **[September 30, 20X2, and 20X1]**, and its net cost of operations, changes in net position, and budgetary resources for the fiscal years then ended in accordance with U.S. generally accepted accounting principles.

Opinion on Internal Control over Financial Reporting

We also have audited **[entity's]** internal control over financial reporting as of **[September 30, 20X2]**, based on criteria established under 31 U.S.C. § 3512(c), (d), commonly known as the Federal Managers' Financial Integrity Act of 1982 (FMFIA). In our opinion, although certain internal controls could be improved, **[entity]** maintained, in all material respects, effective internal control over financial reporting as of **[September 30, 20X2]**, based on criteria established under FMFIA. As discussed below in more detail, our **[20X2]** audit identified deficiencies in **[entity's]** controls over **[describe account or process where significant deficiency identified, for example, accounts receivable process]** that collectively represent a significant deficiency in **[entity's]** internal control over financial reporting.[19] We considered this significant deficiency in determining the nature, timing, and extent of our audit procedures on **[entity's]** fiscal year **[20X2]** financial statements.

Although the significant deficiency in internal control did not affect our opinion on **[entity's]** fiscal year **[20X2]** financial statements, misstatements may occur in unaudited financial information reported internally and externally by **[entity]** because of this significant deficiency.

[If applicable] In addition to the significant deficiency in internal control over **[insert description of significant deficiency from above]**, we also identified other deficiencies in **[entity's]** internal control over financial reporting that we do not consider to be material weaknesses or significant deficiencies. Nonetheless, these deficiencies warrant **[entity]** management's attention. We have communicated these matters to **[entity]** management and, where appropriate, will report on them separately.[20]

Significant Deficiency in Internal Control over **[briefly name the deficiency]**

[Describe significant deficiency, including any progress or changes in the internal control deficiencies identified if they were previously reported.]

Basis for Opinions

We conducted our audits in accordance with U.S. generally accepted government auditing standards. Our responsibilities under those standards are further described in the Auditor's

[18]Note to auditor: The names of the financial statements should be modified as appropriate.

[19]A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis.

[20]Note to auditor: If applicable, consider adding the following sentence to the beginning of the paragraph "We will be reporting additional details concerning this significant deficiency separately to **[entity]** management, along with recommendations for corrective actions."

Responsibilities for the Audits of the Financial Statements and Internal Control over Financial Reporting section of our report. We are required to be independent of **[entity]** and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audits. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

[Note: If applicable, insert emphasis-of-matter paragraph(s), other-matter paragraph(s), or both in accordance with AU-C 706. Include related heading(s).]

Responsibilities of Management for the Financial Statements and Internal Control over Financial Reporting

Management is responsible for

- the preparation and fair presentation of the financial statements in accordance with U.S. generally accepted accounting principles;
- preparing, measuring, and presenting the RSI in accordance with U.S. generally accepted accounting principles;
- preparing and presenting other information included in **[entity's] [insert name of annual report, e.g., agency financial report]**, and ensuring the consistency of that information with the audited financial statements and the RSI;
- designing, implementing, and maintaining effective internal control over financial reporting relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error;
- assessing the effectiveness of internal control over financial reporting based on the criteria established under FMFIA; and
- its assessment about the effectiveness of internal control over financial reporting as of **[September 30, 20X2]**, included in the accompanying Management's Report on Internal Control over[21] Financial Reporting **[or other title of management's report]** in appendix I.

[For entities that conform to FASB standards] In preparing the financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about **[entity's]** ability to continue as a going concern for a reasonable period of time.

Auditor's Responsibilities for the Audits of the Financial Statements and Internal Control over Financial Reporting

Our objectives are to (1) obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and whether effective internal control over financial reporting was maintained in all material respects, and (2) issue an auditor's report that includes our opinions. Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit of the financial statements or an audit of internal control over financial reporting conducted in accordance with U.S. generally accepted government auditing standards will always detect a material misstatement or a material weakness when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may

[21]Note to auditor: GAO does not capitalize the "o" in "over" in the phrase "internal control over financial reporting" when used in a heading or title. However, when referring to the title of management's report included with the auditor's report, the wording and capitalization should be consistent with management's presentation.

involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements, including omissions, are considered to be material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements.[22]

In performing an audit of financial statements and an audit of internal control over financial reporting in accordance with U.S. generally accepted government auditing standards, we:

- Exercise professional judgment and maintain professional skepticism throughout the audits.
- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.
- Obtain an understanding of internal control relevant to our audit of the financial statements in order to design audit procedures that are appropriate in the circumstances.
- Obtain an understanding of internal control relevant to our audit of internal control over financial reporting, assess the risks that a material weakness exists, and test and evaluate the design and operating effectiveness of internal control over financial reporting based on the assessed risk. Our audit of internal control also considered **[entity's]** process for evaluating and reporting on internal control over financial reporting based on criteria established under FMFIA. We did not evaluate all internal controls relevant to operating objectives as broadly established under FMFIA, such as those controls relevant to preparing performance information and ensuring efficient operations. We limited our internal control testing to testing controls over financial reporting. Our internal control testing was for the purpose of expressing an opinion on whether effective internal control over financial reporting was maintained, in all material respects. Consequently, our audit may not identify all deficiencies in internal control over financial reporting that are less severe than a material weakness.
- Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the financial statements.
- Perform other procedures we consider necessary in the circumstances.
- **[For entities that conform to FASB standards]** Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about **[entity's]** ability to continue as a going concern for a reasonable period of time.

We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control–related matters that we identified during the financial statement audit.

[22]Note to auditor: Statement of Federal Financial Accounting Concepts (SFFAC) 1 issued by FASAB provides a slightly different definition of materiality. Since SFFACs are nonauthoritative, and in SFFAC 1, the board recognizes differences from the audit definition, the FAM is based on the definition provided in AU-C 200.07.

Definition and Inherent Limitations of Internal Control over Financial Reporting

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel. The objectives of internal control over financial reporting are to provide reasonable assurance that

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

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct, misstatements due to fraud or error. We also caution that projecting any evaluation of effectiveness to future periods is subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Required Supplementary Information

U.S. generally accepted accounting principles issued by the Federal Accounting Standards Advisory Board (FASAB) require that the RSI be presented to supplement the financial statements. Such information is the responsibility of management and, although not a part of the financial statements, is required by FASAB, which considers it to be an essential part of financial reporting for placing the financial statements in appropriate operational, economic, or historical context.

We have applied certain limited procedures to the RSI in accordance with U.S. generally accepted government auditing standards. These procedures consisted of (1) inquiring of management about the methods used to prepare the RSI and (2) comparing the RSI for consistency with management's responses to our inquiries, the financial statements, and other knowledge we obtained during the audit of the financial statements, in order to report omissions or material departures from FASAB guidelines, if any, identified by these limited procedures. We did not audit and we do not express an opinion or provide any assurance on the RSI because the limited procedures we applied do not provide sufficient evidence to express an opinion or provide any assurance.[23]

Other Information

[Entity's] other information contains a wide range of information, some of which is not directly related to the financial statements. This information is presented for purposes of additional analysis and is not a required part of the financial statements or the RSI. Management is responsible for the other information included in **[entity's] [insert name of annual report, e.g., agency financial report]**. The other information comprises the following sections: **[list section titles of other information included in the annual report]**. Other information does not include the financial statements and our auditor's report thereon. Our opinion on the financial

[23]Note to auditor: Refer to AU-C 730.08d through .08g; .09; and .A3, illustrations 2 through 6, if (1) the auditor is unable to complete the procedures described in this paragraph, (2) some or all of the RSI is omitted, (3) the measurement or presentation of the RSI departs materially from the prescribed guidelines, or (4) the auditor has unresolved doubts about whether the RSI is measured or presented in accordance with prescribed guidelines.

statements does not cover the other information, and we do not express an opinion or any form of assurance thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and consider whether a material inconsistency exists between the other information and the financial statements, or the other information otherwise appears to be materially misstated. If, based on the work performed, we conclude that an uncorrected material misstatement of the other information exists, we are required to describe it in our report.[24]

Report on Compliance with Laws, Regulations, Contracts, and Grant Agreements

In connection with our audits of **[entity's]** financial statements, we tested compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements consistent with our auditor's responsibilities discussed below.

Results of Our Tests for Compliance with Laws, Regulations, Contracts, and Grant Agreements

Our tests for compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements disclosed no instances of noncompliance for **[fiscal year 20X2]** that would be reportable under U.S. generally accepted government auditing standards. However, the objective of our tests was not to provide an opinion on compliance with laws, regulations, contracts, and grant agreements applicable to **[entity]**. Accordingly, we do not express such an opinion.

Basis for Results of Our Tests for Compliance with Laws, Regulations, Contracts, and Grant Agreements

We performed our tests of compliance in accordance with U.S. generally accepted government auditing standards.

Responsibilities of Management for Compliance with Laws, Regulations, Contracts, and Grant Agreements

[Entity] management is responsible for complying with laws, regulations, contracts, and grant agreements applicable to **[entity]**.

Auditor's Responsibilities for Tests of Compliance with Laws, Regulations, Contracts, and Grant Agreements

Our responsibility is to test compliance with selected provisions of laws, regulations, contracts, and grant agreements applicable to **[entity]** that have a direct effect on the determination of material amounts and disclosures in **[entity's]** financial statements, and perform certain other limited procedures. Accordingly, we did not test compliance with all provisions of laws, regulations, contracts, and grant agreements applicable to **[entity]**. We caution that noncompliance may occur and not be detected by these tests.

Intended Purpose of Report on Compliance with Laws, Regulations, Contracts, and Grant Agreements

The purpose of this report is solely to describe the scope of our testing of compliance with selected provisions of applicable laws, regulations, contracts, and grant agreements, and the results of that testing, and not to provide an opinion on compliance. This report is an integral part of an audit performed in accordance with U.S. generally accepted government auditing

[24]Note to auditor: Refer to AU-C 720.24f; .25; and .A62, illustration 2, if the auditor has concluded that an uncorrected material misstatement of the other information exists.

standards in considering compliance. Accordingly, this report on compliance with laws, regulations, contracts, and grant agreements is not suitable for any other purpose.

Agency Comments [If applicable, add "and Our Evaluation." Heading should be consistent with related wording on page 595 B-9.]

In commenting on a draft of this report, **[entity[25]]** ……The complete text of **[entity's]** response is reprinted in appendix II.

[Signature]

[Title]

[Date of auditor's report]

[25]Note to auditor: For GAO reports, only the entity name is cited in this section if the entity provides written comments. Do not include the name or title of the commenting official. If the entity provides email or oral comments, the title of the commenting official is included. See Words@Work on the GAO intranet.

595 C – Accumulating Misstatements

.01 As discussed in FAM 540, the auditor should accumulate misstatements identified during the audit (other than those that are clearly trivial). The paragraphs and illustrative examples that follow provide guidance on preparing the summary of uncorrected misstatements (SUM), including the list of adjusting entries needed to correct the uncorrected misstatements, and preparing the summary of corrected misstatements.

Prepare Summary of Uncorrected Misstatements

.02 When accumulating uncorrected misstatements, the auditor should prepare the list of adjusting entries needed to correct the uncorrected misstatements, including any nontrivial misstatements that management brings to the auditor's attention that management has not corrected, under the balance sheet approach. The auditor should also list the adjustments to transition from the balance sheet approach to the net cost approach (i.e., reversal of net cost misstatements included in the prior-year SUM under the balance sheet approach). The misstatements under the current-year balance sheet approach carry over to the net cost approach and are not included as transition adjustments.[1]

.03 The **balance sheet approach** quantifies a misstatement with the objective of making the balance sheet correct as of the end of the current year. The other side(s) of the entry to correct the balance sheet is(are) generally made to the statement of net cost within the appropriate components of net cost (e.g., gross cost or earned revenue).[2]

An example of a misstatement that would be quantified under the balance sheet approach is an understatement of accrued liabilities at the end of the current year and a corresponding understatement of gross cost. The adjustment to correct the balance sheet would be to credit accrued liabilities and debit gross cost. In addition, the following misstatements would be quantified under the balance sheet approach:[3]

- Misstatements solely within the balance sheet, statement of net cost, or statement of changes in net position.[4]

[1]The balance sheet and net cost approaches are also known as iron curtain and rollover approaches, respectively. The auditor considers the effect of misstatements on all financial statements under each of these approaches.

[2]In some instances, the other side(s) of the entry to correct the balance sheet may be made directly to the statement of changes in net position (e.g., for nonexchange revenue to recipient entities, transfers, etc.).

[3]The effects of these two types of misstatements are included under both the balance sheet and net cost approaches to consider their aggregate effect on individual line items under both approaches.

[4]Misstatements that are solely within the balance sheet could be between assets, between liabilities, or between assets and liabilities. Misstatements that are solely within the statement of net cost could be between responsibility segments or between gross cost and exchange revenue. Misstatements that are solely within the statement of changes in net position could be between unexpended appropriations and cumulative results of operations. Although misstatements that are solely within the statement of net cost or statement of changes in net position do not affect the balance sheet, the auditor would still quantify those misstatements under the balance sheet approach with the objective of correcting the affected financial statements.

- Misstatements affecting both the statement of net cost and statement of changes in net position (e.g., misclassification between earned revenue and nonexchange revenue), other than the carryover of total net cost from the statement of net cost to the net cost of operations line item on the statement of changes in net position.

.04 The **net cost approach** quantifies a misstatement with the objective of making the current-year statement of net cost correct. Under this approach, the auditor quantifies misstatements from two sources:

- all misstatements under the **current-year** balance sheet approach (as discussed above) and
- reversal of net cost misstatements included in the **prior-year** SUM under the balance sheet approach, with the offsetting entry to beginning net position (transition adjustments from the balance sheet approach to the net cost approach).[5]

An example of a misstatement that would be quantified under the net cost approach only (i.e., balance sheet approach results in no adjustments) is a cutoff error at the end of the prior year. The entity overaccrued liabilities and gross cost on its prior-year financial statements, resulting in current year costs being recorded on its prior-year financial statements. The prior-year SUM under the balance sheet approach included a debit entry to accrued liabilities and a credit entry to gross cost. The adjustment to correct the statement of net cost in the current year would be a debit entry to gross cost, which reverses the prior-year credit entry to gross cost, and a credit entry to beginning net position.

.05 The following two examples illustrate the application of the balance sheet and net cost approaches. They are reflected in FAM 595 C, example 1, tables I and II. Auditors should also consider the budgetary effects of the misstatements on the statement of budgetary resources, such as the need to record an obligation. The examples discussed below do not consider any effect on the statement of budgetary resources.

a. **Example 1:** The auditor identified an improper expense accrual in Program A at the end of the current year of $100,000, which has accrued at $20,000 per year over 5 years.

- Year 1 – 4 (prior years): Other Liabilities is overstated by a cumulative amount of $80,000 through year 4. This amount is included in the prior-year SUM under the balance sheet approach.
- Year 5 (current year): Other Liabilities is overstated by an additional $20,000 in the current year (included in gross cost), resulting in a cumulative overstatement of $100,000 through year 5.

[5]Generally, comparative financial statements are presented, and a SUM is prepared for both the current-year and prior-year financial statements. The prior-year SUM should be updated for any misstatements identified in the current-year audit that affect the prior-year financial statements and, as appropriate, for any other changes based on updated information. The reversal of net cost misstatements included in the updated prior-year SUM under the balance sheet approach would be in the current-year SUM as transition adjustments from the balance sheet approach to the net cost approach. For example, if the prior-year SUM under the balance sheet approach had a debit entry to other liabilities and a credit entry to gross costs, the reversal of the net cost entry in the current year would be a debit to gross cost, with an offsetting credit entry to beginning net position.

Under the **balance sheet** approach, the auditor quantifies the misstatement based on correcting the misstatement in the balance sheet at the end of the current year and making an offsetting entry to current-year gross cost. In this example, the adjusting entries would be a debit to other liabilities for $100,000 and a corresponding credit to current-year gross cost (see FAM 595 C, example 1, table I, adjusting entry 6a).

Under the net cost approach, the auditor quantifies the misstatement based on correcting the misstatement in the current-year statement of net cost. This is composed of two parts:

- all misstatements under the **current-year** balance sheet approach (debit other liabilities and credit gross cost of $100,000) (discussed above) and
- reversal of net cost misstatements under the **prior-year** balance sheet approach, with the offsetting entry to beginning net position (debit gross cost and credit beginning net position of $80,000).

The $100,000 entry is recorded on the SUM under the current-year balance sheet approach, and the $80,000 entry is an adjustment to transition the balance sheet approach to the net cost approach. The result of these two parts is a $100,000 debit entry to other liabilities, $80,000 credit entry to beginning net position, and net $20,000 credit entry to gross cost. The auditor would record the $80,000 reversal of net cost misstatements under the **prior-year** balance sheet approach as an adjustment to transition the balance sheet approach to the net cost approach (see FAM 595 C, example 1, table I, adjusting entry 6b).

b. **Example 2:** The auditor identified an overaccrual of other liabilities and gross cost during the **prior-year** audit, in which $300,000 of Program A gross cost related to the **current year** was improperly accrued in the **prior year**. The **prior-year** SUM under the balance sheet approach included a debit entry to other liabilities and a credit entry to gross cost of $300,000. Because management chose not to record the adjustment in the **prior-year** audit, the **current-year** expense is understated by $300,000. Other liabilities are properly stated at the end of the current year.

   Because the misstatement does not affect the balance sheet at the end of current year and is not a misstatement that would be quantified under the balance sheet approach as discussed in FAM 595 C.06, no adjusting entry is needed under the **balance sheet** approach.

   Under the **net cost** approach, the auditor quantifies the misstatement based on correcting the misstatement in the current-year statement of net cost. In this example, since there is no effect under the **current-year** balance sheet approach, the misstatement (and transition from the current-year balance sheet approach) is composed of the reversal of net cost misstatements under the **prior-year** balance sheet approach, with the offsetting entry to beginning net position. In this example, the adjusting entries in the current year would be a debit to gross cost for $300,000 and a corresponding credit to beginning net position. The auditor would record an adjusting entry to transition from the balance sheet approach to the net cost approach (see FAM 595 C, example 1, table I, adjusting entry 7).

.06 The list of adjusting entries needed to correct the uncorrected misstatements under the balance sheet approach and the adjustments to transition from the

balance sheet approach to the net cost approach would typically include the following information (see FAM 595 C, example 1, table I):

a. reference to an adjustment number or documentation reference;

b. whether the misstatement is factual, judgmental, or projected;

c. description of the adjustment;

d. *U.S. Standard General Ledger* (USSGL) account numbers and line items affected in the entity's financial statements;

e. indication of whether each USSGL/line item affected is a federal intragovernmental (F) or a nonfederal public account (N); and

f. amounts of the debit and credit.

.07 The auditor should prepare a SUM or equivalent documentation (AU-C 450.12b) based on the list of adjusting entries needed to correct the uncorrected misstatements to show the financial statement effect of the uncorrected misstatements under both the balance sheet and net cost approaches (see FAM 595 C, example 1, table II).

.08 The auditor enters the adjusting entries needed to correct the uncorrected misstatements under the balance sheet approach and the adjustments to transition from the balance sheet approach to the net cost approach on the SUM. These entries are entered in the following columns as shown on the illustrative example in FAM 595 C, example 1, table II.

- The misstatements under the balance sheet approach are entered in column 4.
- The adjustments to transition from the balance sheet approach to the net cost approach are entered in column 7.

The auditor then completes the other columns on the SUM to show the adjusted line item balances under the balance sheet approach in column 5 and the adjusted line item balances under the net cost approach in column 8. The auditor also completes the related information on the statement of changes in net position, including the effect of the adjustments on the balance sheet and statement of net cost. While not presented in the illustrative example in FAM 595 C, example 1, table II, the auditor should also consider the budgetary effects of the misstatements on the statement of budgetary resources, such as the need to record an obligation.

.09 The auditor should also consider and document the effects (other than clearly trivial) of uncorrected misstatements (including omissions) on the notes to the entity's financial statements on a quantitative and qualitative basis. Such information related to the notes would typically include the note number, note name, and a description of the misstatement (see FAM 595 C, example 1, table III).

.10 As discussed in FAM 540.14, the auditor should communicate the uncorrected misstatements accumulated on the SUM with management. Management is responsible for determining whether the uncorrected misstatements on the SUM are material, individually or in the aggregate, to the entity's financial statements under either the net cost or balance sheet approach and whether to make any further adjustments to the financial statements. If management makes any further

adjustments to correct the misstatements accumulated on the SUM, the auditor should update the (1) list of adjusting entries needed to correct the uncorrected misstatements to accumulate only those that remain uncorrected, (2) SUM, and (3) summary of corrected misstatements (see FAM 595 C.13–.14 below). In the illustrative example in FAM 595 C, examples 1 and 2, management has declined to record adjusting entries 1 through 4, 6, and 7, and declined to correct note 17 because management has determined that they are immaterial to the financial statements. Management has agreed to record adjusting entry 5 and correct notes 10 and 19 because management has determined that they are material to the financial statements.

.11 The auditor should provide the final SUM (see FAM 595 C, example 1), including any uncorrected misstatements on the notes to the financial statements, without the auditor's calculations, evaluation, and conclusion, to management as an attachment to the management representation letter, as discussed in FAM 1001.

.12 The SUM should include management's conclusion about whether uncorrected misstatements are material, individually or in the aggregate, and the basis for that conclusion (including consideration of the balance sheet and net cost approaches). The SUM should also include the auditor's conclusion about whether uncorrected misstatements are material, individually or in the aggregate, and the basis for that conclusion (AU-C 450.12c). The auditor's conclusion should include consideration of the balance sheet and net cost approaches. The SUM should also discuss any differences between management's and the auditor's conclusions and its effect on the audit conclusions or report. The SUM should indicate that the auditor communicated the effects of the uncorrected misstatements on the financial statements with those charged with governance (see FAM 595 C, example 1, table 2).

Prepare Summary of Corrected Misstatements

.13 The auditor should accumulate misstatements for financial statement line items that the auditor has identified and management has corrected in the summary of corrected misstatements. The summary of corrected misstatements would typically include the information listed in FAM 595 C.06 (see FAM 595 C, example 2, table I).

.14 The auditor should also consider and document the effects (other than clearly trivial) of corrected misstatements on the notes to the entity's financial statements on a quantitative and qualitative basis. Such information related to the notes would typically include the note number, note name, and a description of the misstatement (see FAM 595 C, example 2, table II).

Example 1 – List of Adjusting Entries Needed to Correct the Uncorrected Misstatements and Summary of Uncorrected Misstatements

Table I lists the adjusting entries needed to correct the uncorrected misstatements accumulated by the auditor (other than those that are clearly trivial) and includes the information listed in FAM 595 C.06. Adjusting entries 6 and 7 illustrate the application of the balance sheet and net cost approaches as discussed in FAM 595 C.05. After discussions with management, the auditor finalizes this table to include only misstatements that management has declined to correct (see FAM 595 C.10). In this example, management decided to record adjusting entry 5 (see example 2) and declined to record all other adjusting entries.

Table I: List of Adjusting Entries Needed to Correct the Uncorrected Misstatements

Adj. #	Factual, judgmental, or projected?	Description of uncorrected misstatement	Federal governmental (F) or nonfederal public (N)	USSGL account number	Financial statement line item	(Dollars in thousands) Debit	Credit
Misstatements under balance sheet approach							
1	Judgmental	To accrue accounts payable for Program A.	N	6100	Gross cost – Program A	$230	
			N	2110	Accounts payable		$230
2	Factual	To decrease operating expenses overstated due to a cutoff error at the end of the current year.	N	2990	Other liabilities	$200	
			N	6100	Gross cost – Program A		$200
3	Factual	To increase current-year loan bad debt expense in Program B. [Actual error amount of an intragovernmental sample item.]	F	6100	Gross cost – Program B	$25	
			F	1310	Accounts receivable		$25
4	Projected	To increase current-year loan bad debt expense in Program B. [Additional projected misstatement as a result of actual error amount of sample item from adj. #3 above projected to the population. Total projected misstatement of $105 less $25 actual misstatement]	F	6100	Gross cost – Program B	$80	
			F	1310	Accounts receivable		$80
6a	Factual	To decrease improper expense accrual for the current year and prior 4 years.	N	2990	Other liabilities	$100	
			N	6100	Gross cost – Program A		$100
Adjustments to transition from balance sheet approach to net cost approach							
6b	Factual	To reverse improper expense accrual as of the end of the prior year.	N	6100	Gross cost – Program A	$80	
			N	3310	Beginning net position		$80
7	Factual	To increase current-year operating expenses understated due to a cutoff error at the end of the prior year.	N	6100	Gross cost – Program A	$300	
			N	3310	Beginning net position		$300

Table II shows the effects of the misstatements that management declined to correct (uncorrected misstatements) based on the list of adjusting entries needed to correct the uncorrected misstatements (see table I above).

Table II: Summary of Uncorrected Misstatements - Effect of Uncorrected Misstatements on Financial Statement Line Items

Line item (Dollars in thousands) (1)	Adjustment number (2)	Line item balance Debit/(Credit) (3)	Misstatements under balance sheet approach Debit/(Credit) (4)	Adjusted line item balance under balance sheet approach Debit/(Credit) (5) = (3) + (4)	Misstatement as percentage of reported line item under balance sheet approach (6) = [(5) – (3)] / (3)	Adjustments to transition from balance sheet approach to net cost approach Debit/(Credit) (7)	Adjusted line item balance under net cost approach Debit/(Credit) (8) = (5) + (7)	Misstatement as percentage of reported line item under net cost approach (9) = [(8) – (3)] / (3)
Balance Sheet:								
Assets								
Intragovernmental:								
Fund Balance with Treasury		40,000	-	40,000	0.00%	-	40,000	0.00%
Accounts receivable, net	3	125	(25)	20	-84.00%	-	20	-84.00%
	4		(80)					
Loans receivable		1,000	-	1,000	0.00%	-	1,000	0.00%
Total intragovernmental		41,125	(105)	41,020	-0.26%	-	41,020	-0.26%
Other than intragovernmental:								
Inventory and related property, net		8,000	-	8,000	0.00%	-	8,000	0.00%
General property, plant and equipment, net		40,000	-	40,000	0.00%	-	40,000	0.00%
Total other than intragovernmental		48,000	-	48,000	0.00%	-	48,000	0.00%
Total assets		89,125	(105)	89,020	-0.12%	-	89,020	-0.12%
Liabilities								
Other than intragovernmental:								
Accounts payable	1	(2,000)	(230)	(2,230)	11.50%	-	(2,230)	11.50%
Other liabilities	2	(5,250)	200	(4,950)	-5.71%	-	(4,950)	-5.71%
	6a		100					
Total other than intragovernmental		(7,250)	70	(7,180)	-0.97%	-	(7,180)	-0.97%
Total liabilities		(7,250)	70	(7,180)	-0.97%	-	(7,180)	-0.97%
Net Position:								
Total net position		(81,875)	35	(81,840)	-0.04%	-	(81,840)	-0.04%
Total liabilities and net position		(89,125)	105	(89,020)	-0.12%	-	(89,020)	-0.12%
Statement of Changes in Net Position:								
Cumulative Results of Operations:								
Beginning Balances	6b	(104,675)	-	(104,675)	0.00%	(80)	(105,055)	0.36%
	7					(300)		
Adjustments:								
Changes in accounting principles		-	-	-	0.00%	-	-	0.00%
Corrections of errors		-	-	-	0.00%	-	-	0.00%
Beginning Balance, as adjusted		(104,675)	-	(104,675)	0.00%	(380)	(105,055)	0.36%
Net Cost of Operations		22,800	35	22,835	0.15%	380	23,215	1.82%
Net Changes in Cumulative Results of Operations		22,800	35	22,835	0.15%	380	23,215	1.82%
Net Position		(81,875)	35	(81,840)	-0.04%	-	(81,840)	-0.04%

Line item (Dollars in thousands) (1)	Adjustment number (2)	Line item balance Debit/(Credit) (3)	Misstatements under balance sheet approach Debit/(Credit) (4)	Adjusted line item balance under balance sheet approach Debit/(Credit) (5) = (3) + (4)	Misstatement as percentage of reported line item under balance sheet approach (6) = [(5) – (3)] / (3)	Adjustments to transition from balance sheet approach to net cost approach Debit/(Credit) (7)	Adjusted line item balance under net cost approach Debit/(Credit) (8) = (5) + (7)	Misstatement as percentage of reported line item under net cost approach (9) = [(8) – (3)] / (3)
Statement of Net Cost:								
Gross Program Costs								
Program A:								
Gross Costs	1	19,800	230	19,730	-0.35%	-	20,110	1.57%
	2		(200)			-		
	6a		(100)			-		
	6b					80		
	7					300		
Less: Earned Revenue		(23,000)	-	(23,000)	0.00%	-	(23,000)	0.00%
Net Costs Program A		(3,200)	(70)	(3,270)	2.19%	380	(2,890)	-9.69%
Program B:								
Gross Costs (nonfederal public)		31,000	-	31,000	0.00%	-	31,000	0.00%
Gross Costs (intragovernmental)	3	500	25	605	21.00%	-	605	21.00%
	4		80					
Less: Earned Revenue		(5,500)	-	(5,500)	0.00%	-	(5,500)	0.00%
Net Costs Program B		26,000	105	26,105	0.40%	-	26,105	0.40%
Total Net Cost of Operations		22,800	35	22,835	0.15%	380	23,215	1.82%

Note: For illustration purposes, this summary includes only line items from the balance sheet, statement of changes in net position, and statement of net cost. The auditor should add other line items from these and other financial statements so that the line items listed on the summary of uncorrected misstatements agree with the entity's financial statements. Sample forms for preparing the summary of uncorrected misstatements electronically are available at https://www.gao.gov/financial_audit_manual (accessed June 6, 2024).

Legend:

(4) Misstatements under balance sheet approach – All misstatements affecting the balance sheet as of the end of the current year are included in this column, including (a) misstatements solely within the balance sheet, statement of net cost, or statement of changes in net position and (b) misstatements affecting both the statement of net cost and statement of changes in net position other than the carryover of total net cost from the statement of net cost to the statement of changes in net position (e.g., misclassification between earned revenue and nonexchange revenue). Misstatements in this column correspond to adjusting entries 1 through 6a.

(5) Adjusted line item balance under balance sheet approach – This column shows the adjusted line item balance after accounting for the effect of misstatements under the balance sheet approach.

(6) Misstatement as percentage of reported line item under balance sheet approach – The effect of misstatements under the balance sheet approach as a percentage of the reported line item balance is shown in this column to help assess the materiality of the misstatement on each line item.

(7) Adjustments to transition from balance sheet approach to net cost approach – This column includes the reversal of net cost misstatements under the prior-year balance sheet approach, with the offsetting entry to beginning net position. Misstatements in this column correspond to adjusting entries 6b and 7.

(8) Adjusted line item balance under net cost approach – This column shows the adjusted line item balance after accounting for the effect of misstatements under the net cost approach.

(9) Misstatement as percentage of reported line item under net cost approach – The effect of misstatements under the net cost approach as a percentage of the reported line item balance is shown in this column to help assess the materiality of the misstatement on each line item.

Table III shows the effects (other than clearly trivial) of uncorrected misstatements (including omissions) on the notes to the entity's financial statements on a quantitative and qualitative basis. Management decided to correct notes 10 and 19 (see example 2) and declined to correct note 17.

Table III: Summary of Uncorrected Misstatements - Effect of Uncorrected Misstatements on the Notes to the Financial Statements

Note no.	Note name	Factual, judgmental, or projected	Description of uncorrected misstatement (qualitative and quantitative)
17	Other Liabilities	F	As included in table I, the other liabilities line item was overstated on the balance sheet by $200,000. The related misstatement in Note 17, Other Liabilities, is a $200,000 overstatement of accrued funded payroll and leave. See adjustment 2.

Auditor's analysis:

We discussed the summary of uncorrected misstatements with Joe Jones, CFO, and Sandra Hawkins, COO, on 11/1/XX. We encouraged them to correct all factual misstatements and to investigate judgmental and projected misstatements. They recorded adjusting entry 5 in the financial statements because they believed it was material. They also corrected the misstatements in notes 10 and 19. When considering the effect of misstatements under the net cost and balance sheet approaches and qualitative factors, they concluded that the other misstatements in the financial statements and note disclosures were not material. They indicated that after the audit, they will consider whether internal controls need to be strengthened in these areas. On 11/4/xx, we communicated the effect of the uncorrected misstatements on the financial statements to those charged with governance.

Conclusion:

The quantitative effect of uncorrected misstatements for net cost is 0.15 percent and 1.82 percent of total net cost of $22,800,000 under the balance sheet and net cost approaches, respectively. The quantitative effect of uncorrected misstatements for assets is -0.12 percent of total assets of $89,125,000 under both the balance sheet and net cost approaches. The quantitative effect of uncorrected misstatements for liabilities is -0.97 percent of total liabilities of ($7,250,000) under both the balance sheet and net cost approaches. The quantitative effect of uncorrected misstatements for net position is -0.04 percent of total net position of ($81,875,000) under both the balance sheet and net cost approaches. The uncorrected misstatements, individually and in the aggregate, did not exceed our established materiality threshold of $X,XXX,XXX. We also considered the effect of uncorrected misstatements on other financial statement line items and whether these misstatements were qualitatively material. We considered whether misstatements in the note disclosures were qualitatively or quantitatively material. Based on our analysis, we concur with management that the uncorrected misstatements were not material to the financial statements as a whole. We also conclude that the scope of procedures performed in light of the total uncorrected misstatements identified above is adequate.

Example 2 – Summary of Corrected Misstatements

Table I shows the misstatements for the financial statement line items that management corrected. See FAM 595 C.13.

Table I: Summary of Corrected Misstatements for Financial Statement Line Items

Adj. #	Factual, judgmental, or projected?	Description of corrected misstatement	Federal governmental (F) or nonfederal public (N)	USSGL account number	Financial statement line item	(Dollars in thousands) Debit	Credit
5	Factual	To adjust Fund balance with Treasury for receipts after cutoff date.	N	5200	Earned revenue - Program B	$10,000	
			F	1010	Fund balance with Treasury		$10,000

Table II shows the misstatements for the notes to the financial statements that management corrected. See FAM 595 C.14.

Table II: Summary of Corrected Misstatements for the Notes to the Financial Statements

Note no.	Note name	Factual, judgmental, or projected	Description of corrected misstatement (qualitative and quantitative)
10	General Property, Plant, and Equipment, Net	F	While this line item was not misstated on the balance sheet, $5,000,000 of equipment was misclassified as internal-use software in the related note. Management corrected this misstatement by reclassifying $5,000,000 from internal-use software to equipment in this note.
19	Commitments and Contingencies	F	Required narrative related to contingent liabilities was omitted. Although the entity recognized the minimum amount in a range of amounts for an estimated liability where no amount within the range was a better estimate than any other amount, it did not disclose the amount recognized, the range, and a description of the nature of the contingency in Note 19, Commitments and Contingencies. Management corrected this misstatement by including the omitted information.

Glossary

Accounting estimate	A monetary amount for which the measurement, in accordance with the requirements of the applicable financial reporting framework (generally U.S. generally accepted accounting principles (U.S. GAAP)), is subject to estimation uncertainty (i.e., susceptibility to an inherent lack of precision in measurement).
Accuracy, valuation, and allocation	Amounts and other data relating to recorded transactions and events have been appropriately recorded. Assets, liabilities, net position, budgetary balances, and projections in sustainability financial statements have been included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments have been appropriately recorded.
Agency financial report (AFR)	As defined by the Office of Management and Budget (OMB), the AFR comprises • unaudited management's discussion and analysis (MD&A), part of required supplementary information (RSI); • audited financial statements, including note disclosures; • unaudited required supplementary information (RSI) (other than the MD&A), if applicable; and • unaudited other information, if applicable.
Analytical procedures	The evaluations of financial information made through analysis of plausible relationships among both financial and nonfinancial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts.
Annual management report (AMR)	A report consisting of the financial statements and related information prepared by government corporation. Government corporations subject to the Government Corporation Control Act are required to submit AMRs to the Congress annually under 31 U.S.C. § 9106.
Annual report	A document containing the audited financial statements and the auditor's report, such as the performance and accountability report, agency financial report, or annual management report.

Applicable financial reporting framework	Provides the criteria for management to present the financial statements of an entity, including the fair presentation of those financial statements (U.S. GAAP). The Federal Accounting Standards Advisory Board (FASAB) is the body designated by the American Institute of Certified Public Accountants as the source of U.S. GAAP for federal reporting entities.
Application controls	Controls that are incorporated directly into software programs, or applications, to help ensure the validity, completeness, accuracy, and confidentiality of transactions and data during information system processing.
Appropriateness	Appropriateness of audit evidence is the measure of the quality of audit evidence, that is, its relevance and reliability in providing support for the conclusions on which the auditor's reports are based.
Appropriation	The most common form of budget authority, appropriations are statutory authority that permits federal entities to incur obligations and to make payments from the Department of the Treasury for specified purposes. Appropriations do not represent cash actually set aside in the Treasury for purposes specified in the appropriation acts. Appropriations represent amounts that entities may obligate during the period specified in the appropriation acts. Periods can be single year, multiyear, or no year.
Assertions	Representations, explicit or otherwise, with respect to the recognition, measurement, presentation, and disclosure of information in the financial statements, which are inherent in management, representing that the financial statements are prepared in accordance with the applicable financial reporting framework (generally U.S. GAAP). The five assertions used in the FAM are as follows: • Existence or occurrence • Completeness • Rights and obligations • Accuracy/valuation or allocation • Presentation and disclosure (Also see significant assertion.)

Assistant director	The person responsible for the operational conduct of the audit and generally for preparation of the audit report. In public accounting firms, the audit manager may have these responsibilities.
Attribute sampling	Statistical sampling that reaches a conclusion about a population in terms of a rate of occurrence.
Audit assurance	The complement of audit risk, which is an auditor judgment. This is not the same as confidence level, which relates to an individual sample.
Audit director (first partner)	The person responsible for the quality of the financial statement audit and the audit report, reporting to the assistant IG for the audit or, at GAO, to the managing director.
Audit documentation	The record of audit procedures performed, audit evidence obtained, and conclusions the auditor reached. Terms such as working papers or workpapers are also sometimes used.
Audit evidence	Information used by the auditor in arriving at the conclusions on which the auditor's reports are based. Audit evidence is information to which audit procedures have been applied and consists of information that corroborates or contradicts assertions in the financial statements.
Audit file	One or more folders or other storage media, in physical or electronic form, containing the records that constitute the audit documentation for a specific engagement.
Audit plan	An audit document that describes • the nature and extent of planned risk assessment procedures; • the nature, timing, and extent of planned further audit procedures at the assertion level; and • other planned audit procedures that are required to be carried out so that the engagement complies with generally accepted government auditing standards.
Audit risk	The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is composed of the risk of material misstatement and detection risk. (Also see risk of material misstatement and detection risk.)

Audit sample (sample)	Items selected from a population to reach a conclusion about the population as a whole. (Compare with nonstatistical selection.)
Audit sampling (sampling)	The selection and evaluation of less than 100 percent of the population of audit relevance such that the auditor expects the items selected (the sample) to be representative of the population and thus likely to provide a reasonable basis for conclusions about the population. In this context, representative means that evaluating the sample will result in conclusions that, subject to the limitations of sampling risk, are similar to those that would be drawn if the same procedures were applied to the entire population. Sampling involves selection techniques that can be applied using either statistical or nonstatistical sampling approaches.
Audit sampling specialist	A statistician or other person the auditor consults for technical expertise in areas such as audit sampling, audit sample evaluation, and selecting entity field locations to test.
Auditor's point estimate or auditor's range	An amount, or range of amounts, respectively, developed by the auditor in evaluating management's point estimate. (Also see management's point estimate.)
Auditor's report date	The date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements.
Balance sheet approach	An approach used to evaluate misstatements. This approach quantifies a misstatement with the objective of making the balance sheet correct as of the end of the current year.
Borrowing authority	Statutory authority that permits federal entities to borrow money and then to obligate against amounts borrowed. The amount to be borrowed may be definite or indefinite in nature, and the purposes for which the borrowed funds are to be used are stipulated by the authorizing statute.
Budget authority	Authority provided by law to allow federal entities to enter into financial obligations that will result in immediate or future outlays involving government funds. The Congress provides an entity with budget authority and may place restrictions on the amount, purpose, and timing of the obligation or outlay of such authority. The basic forms of budget authority include (1) appropriations, (2) borrowing authority, (3) contract

	authority, and (4) authority to obligate and expend offsetting receipts and collections.
Budget controls	Management's policies and procedures for managing and controlling the use of appropriated funds and other forms of budget authority.
Budgetary resources	An amount available to enter into new obligations and to liquidate them. Budgetary resources are made up of new budget authority (including direct spending authority provided in existing statute and obligation limitations) and unobligated balances of budget authority provided in previous years. (Also see budget authority.)
Canceled (closed) account	An appropriation account whose balance has been canceled. Once balances are canceled, the amounts are not available for obligation or expenditure for any purpose.
Cause and effect basis	In cost accounting, a way to group costs into cost pools in which an intermediate activity may be a link between the cause and the effect.
Class of transactions	A category of events or activities that result in the recording of, or that support, financial data in the entity's general ledger accounts and, ultimately, the reporting of financial statement line items or disclosure of information in the notes to the financial statements. Classes of transactions are classified as transaction related (e.g., cash receipts) or line item/account related (e.g., cash balance).
Classical probability proportional to size sampling	A sample selection procedure that selects items for the sample in proportion to their relative size, usually their monetary amounts. Monetary unit sampling uses this method to select the sample.
Classical variables sampling	A sampling approach that measures sampling risk using the variation of the underlying characteristic of interest. This approach includes methods such as mean-per-unit, ratio estimation, difference estimation, and a classical form of probability proportional to size estimation.
Clearly trivial	The amount below which misstatements would not need to be accumulated because the auditor expects that the accumulation of such amounts clearly would not have a material effect on the financial statements.
Client	In the federal environment, the client may include the • management of the federal entity to be audited, including senior executive and financial managers;

	• inspector general (IG) if the IG has contracted for the audit; • members of a board or commission responsible for the federal entity; and/or • audit committee.
Combined precision	The achieved precision for all statistical sampling applications.
Commitment	For budgetary accounting, an administrative reservation of allotted funds, or of other funds, in anticipation of their obligation. For proprietary accounting, this includes a binding agreement that may result in the future expenditure of financial resources.
Commitment letter	A letter used by some auditors, either after a survey of work or the planning phase has been completed to confirm a commitment for a congressional request, mandate, or auditor's statutory discretionary authority for any type of work.
Common data source	All of the financial and programmatic information available for the budgetary, cost, and financial accounting processes. It includes all financial and much nonfinancial data, such as environmental data, that are necessary for budgeting and financial reporting as well as evaluation and decision information developed as a result of prior reporting and feedback.
Comparative financial statements	A complete set of financial statements for one or more prior periods included for comparison with the financial statements of the current period.
Comparative information	Prior period information presented for purposes of comparison with current period amounts or note disclosures that is not in the form of a complete set of financial statements. Comparative information includes prior period information presented as condensed financial statements or summarized financial information.
Compensating control	A control that limits the severity of a control deficiency and prevents it from rising to the level of significant deficiency or, in some cases, a material weakness. Only compensating controls that operate at a level of precision that would prevent, or detect and correct, a material misstatement are capable of having a mitigating effect. Although compensating controls can mitigate the effects of a control deficiency, they do not eliminate the control deficiency.

Complementary user entity controls	Controls that management of the service organization assumes, in the design of its service, will be implemented by entities that use its service and are necessary to achieve control objectives stated in management's description of the service organization's system.
Completeness	All transactions and events that should have been recorded have been recorded in the proper period and accounts. All assets, liabilities, net position, and budgetary balances that should have been recorded have been recorded in the proper period and accounts, and properly included in the financial statements. Projections in the sustainability financial statements include all estimated future revenues and expenditures at present value that should have been included.
Compliance control	A process, by management and others, designed to provide reasonable assurance regarding the achievement of objectives for compliance with applicable laws, regulations, contracts, and grant agreements.
Compliance control tests	Tests to obtain evidence on the entity's compliance controls for each significant provision of applicable laws, regulations, contracts, and grant agreements identified for testing, including budget controls for each relevant budget restriction.
Compliance system	The entity's policies and procedures to monitor compliance with laws, regulations, contracts, and grant agreements applicable to the entity.
Compliance tests	Tests to obtain evidence on the entity's compliance with each significant provision of applicable laws, regulations, contracts, and grant agreements identified for testing, including compliance with relevant budget restrictions.
Component auditor	An auditor who performs work on the financial information of a component that will be used as audit evidence for the group audit.
Confidence interval	A statistical sample-based estimate expressed as an interval or range of values. The sample is designed such that there is a specified confidence level for which the population value being estimated is expected to be located within the interval. More specifically, it is the projected misstatement plus or minus precision at the desired confidence level and is also known as a precision or precision interval.

Confidence level	The probability associated with the precision, that is, the probability that the true misstatement is within the confidence interval. This is not the same as assurance.
Contingency	An existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss to an entity. The uncertainty will ultimately be resolved when one or more future events occur or fail to occur.
Contract authority	Statutory authority that permits obligations to be incurred in advance of appropriations or in anticipation of receipts to be credited to a revolving fund or other account (offsetting collections). Contract authority is unfunded. Subsequent funding by an appropriation or by offsetting collections is needed to liquidate the obligations incurred under the contract authority.
Control activities	One of the five components of internal control, in addition to control environment, entity risk assessment, information and communication, and monitoring. Control activities are the actions management establishes through policies and procedures to achieve objectives and respond to risks in the internal control system, which includes the entity's information system. "Control activities" as used in the FAM are referred to as controls in the control activities component in the AICPA *Codification of Statements on Auditing Standards* (AU-C), Section 540, *Auditing Accounting Estimates and Related Disclosures*. "Control activities" as used in the FAM also include controls in the control environment, entity risk assessment, information and communication, and monitoring components that directly address risks of material misstatement at the assertion level.
Control deficiency	A condition when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. (Also see significant deficiency and material weakness.)
Control environment	One of the five components of internal control, in addition to entity risk assessment, control activities, information and communication, and monitoring. The control environment is the foundation for an internal control system. It provides the discipline and structure to help an entity achieve its objectives.

Control objective	The aim or purpose of specified controls. Control objectives address the risks that the controls are intended to mitigate. In the context of internal control over financial reporting, a control objective generally relates to a significant assertion in a material line item, account, note disclosure, or class of transactions, and addresses the risk that the controls will not provide reasonable assurance that a misstatement or omission in that assertion is prevented, or detected and corrected, on a timely basis.
Control risk	The risk that a misstatement that could occur in an assertion about a line item, account, note disclosure, or class of transactions and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control. Control risk is a function of the effectiveness of the design and operation of internal control in achieving the entity's objectives relevant to the preparation and fair presentation of the entity's financial statements. Some control risk will always exist because of the inherent limitations of internal control.
Control tests	Audit procedures designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.
Cost	The monetary value of resources used or sacrificed or liabilities incurred to achieve an objective, such as to acquire or produce a good or to perform an activity or service.
Cycle	A grouping of related line items, accounts, note disclosures, and classes of transactions.
Cycle matrix	An audit document that links material line items, accounts, note disclosures, and classes of transactions to related significant financial management systems, line item risk analysis forms, and cycles, as applicable.
Degree of compliance	The following terms are used throughout the FAM to describe the degree of compliance with the standard or policy. • **Must**: Compliance is mandatory when the circumstances exist to which the requirement is relevant. Most "musts" indicate unconditional requirements that come directly from professional auditing standards while other instances of "must" are unique needs for the government environment

and, therefore, GAO/CIGIE determined them to be required.

- **Should**: Compliance is mandatory when the circumstances exist to which the requirement is relevant, except in rare circumstances when the specific procedure to be performed would be ineffective in achieving the intent of the requirement. The auditor must document (1) the justification for any departure and (2) how the alternative audit procedures performed were sufficient to achieve the intent of the requirement or policy. The documentation must be provided to the reviewer in a timely manner to allow any issues to be promptly identified and resolved.
- **Generally should**: Compliance is strongly encouraged when the circumstances exist to which this policy is relevant. The auditor should discuss any departure with the assistant director (or equivalent, such as the audit manager in a public accounting firm) and document such discussions.
- **May, might, could**: These terms are used in the FAM to provide further explanation of and guidance for implementing audit requirements. Compliance is optional. The auditor need not document compliance.

Deobligation

An entity's cancellation or downward adjustment (i.e., reduction) of previously incurred obligations. The entity should not cancel or reduce an obligation until it has made a formal decision to do so, supported by any necessary documentation that has been fully executed (e.g., SF-30 for contract amendments). There may be specific statutory or other requirements concerning deobligation.

Deobligated funds may be reobligated within the period of availability of the appropriation. For example, annual appropriated funds may be reobligated in the fiscal year in which the funds were appropriated, while multiyear or no-year appropriated funds may be reobligated in the same or subsequent fiscal years.

Detection risk

The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements. It is a function of the effectiveness of an audit procedure and of its application by the auditor.

Direct assistance	The use of internal auditors to perform audit procedures under the direction, supervision, and review of the auditor.
Disclosure entities	Organizations similar to consolidation entities in that they are either (1) in the budget, (2) majority owned by the government, (3) controlled by the government, or (4) would be misleading to exclude. Disclosure entities have a greater degree of autonomy with the government than consolidation entities.
Disclosures	See note disclosures.
Documentation completion date	The date, no later than 60 days following the report release date, on which the auditor has assembled for retention a complete and final set of documentation in an audit file.
Emphasis-of-matter paragraph	A paragraph included in the auditor's report that is required by U.S. GAAS, or is included at the auditor's discretion, and that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's professional judgment, is of such importance that it is fundamental to users' understanding of the financial statements.
Engagement letter	A written agreement that documents the objectives and scope, roles and responsibilities of both management and the auditor, and other matters of the engagement.
Entity-level controls	Controls that have a pervasive effect on an entity's internal control system. Entity-level controls may include controls related to the entity's risk assessment process, control environment, service organizations, management override, and monitoring.
Entity management	The persons with executive responsibility for the conduct of the entity's operations.
Entity profile	An audit document that contains information useful for understanding the entity's operations, including (1) its environment, legal and regulatory framework, accounting policies, use of accounting estimates, and relationships and transactions with disclosure entities, related parties, and public-private partnerships; (2) the applicable financial reporting framework (generally U.S. GAAP); and (3) the effect of inherent risk factors on the preparation of the financial statements.
Entity risk assessment	One of the five components of internal control, in addition to control environment, control activities, information and communication, and monitoring.

	Entity risk assessment is the assessment of the risks facing the entity as it seeks to achieve its objectives. This assessment provides the basis for developing appropriate risk responses.
Errors	Unintentional actions, such as mathematical mistakes, mistakes in the application of accounting principles, or oversight or misuse of facts, that existed at the time the financial statements were prepared.
Existence or occurrence	Transactions and events have occurred during the given period, have been recorded in the proper accounts, and pertain to the entity. An entity's assets, liabilities, net position, and budgetary balances exist at a given date and have been recorded in the proper accounts. Projected revenues and expenditures in the sustainability financial statements are valid.
Expectation	The auditor's estimate of a recorded amount (based on an analysis and understanding of relationships between the recorded amounts and other data) in an analytical procedure.
Expected misstatement	The dollar amount of misstatements the auditor expects in a population.
Expired accounts (appropriations)	Accounts in which the balances are no longer available for incurring new obligations because the time available for incurring such obligations has expired.
External confirmation	Audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), either in paper form or by electronic or other medium (for example, through the auditor's direct access to information held by a third party).
Factual misstatement	A misstatement in which there is no doubt about the misstatement.
Federal financial management systems requirements	Consists of three parts: (1) reliable financial reporting, (2) effective and efficient operations, and (3) compliance with applicable laws and regulations. OMB and Treasury develop, issue, and maintain the federal financial management systems requirements to support these areas and publish them in the *Treasury Financial Manual*.
Federal reporting entities	Reporting entities are organizations that issue a general purpose federal financial report because either there is a statutory or administrative requirement to prepare one or they choose to prepare one. The term "reporting entity" may refer to either the government-wide reporting entity or a component reporting entity. Statement of Federal

	Financial Accounting Concepts (SFFAC) 2 provides criteria for an entity to be a reporting entity.
Financial management systems	The financial systems and the financial portions of mixed systems necessary to support financial management, including automated and manual processes, procedures, controls, data, hardware, software, and support personnel dedicated to the operation and maintenance of system functions.
Financial reporting control	A process, created by management and other personnel, designed to provide reasonable assurance regarding the achievement of financial reporting objectives.
Financial statements (also called the basic or principal financial statements)	A component of a federal entity's annual report (e.g., PAR or AFR), which consists of the following presented on a comparative basis for the current and prior years: • balance sheets, • statements of net cost, • statements of changes in net position, • statements of budgetary resources, • statements of custodial activity (if applicable), • statements of social insurance (if applicable), • statements of changes in social insurance amounts (if applicable), and • related note disclosures.
Fraud	An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception that results in a misstatement in financial statements that are the subject of an audit. (Also see fraudulent financial reporting and misappropriation of assets.)
Fraud risk	An identified risk of material misstatement due to fraud. (Also see identified risk of material misstatement.)
Fraudulent financial reporting	Intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users. Fraudulent financial reporting could involve intentional alteration of accounting records, misrepresentation of transactions, intentional misapplication of accounting principles, or other means.

Full cost	The total amount of resources used to produce the output. More specifically, the full cost of an output produced by a responsibility segment is the sum of (1) the costs of resources consumed by the responsibility segment that directly or indirectly contribute to the output and (2) the costs of identifiable supporting services provided by other responsibility segments within the reporting entity and by other reporting entities.
Fund Balance with Treasury (FBWT)	An intragovernmental asset account representing the unexpended spending authority in entity appropriations. FBWT also serves as a mechanism to prevent entity disbursements from exceeding appropriated amounts.
General controls	General controls are the policies and procedures that apply to all or a large segment of an entity's information system. General controls help ensure the proper operation of information systems by creating the environment for proper operation of application controls.
Generally should	See degree of compliance.
Haphazard sample	A nonstatistical sample consisting of sampling units selected without any conscious bias, that is, without any special reason for including or omitting items from the sample. It does not consist of sampling units selected in a careless manner; rather it is selected in a manner the auditor expects to be representative of the population.
Heritage assets	Property, plant, and equipment that are unique for one or more of the following reasons: (1) historical or natural significance, (2) cultural, educational, artistic (or aesthetic) importance, or (3) significant architectural characteristics.
Identified risk of material misstatement at the assertion level	A potential misstatement that could occur in an entity's assertion for a material line item, account, note disclosure, or class of transactions.
Identified risk of material misstatement at the financial statement level	A risk of material misstatement that relates pervasively to the financial statements as a whole and potentially affects many assertions. Risks of this nature are not necessarily risks identifiable with specific assertions at the line item, account, note disclosure, or class of transactions level. Rather, they represent circumstances that may pervasively increase the risks of material misstatement at the assertion level. (Also see risk of material misstatement.)

Information and communication	One of the five components of internal control, in addition to control environment, entity risk assessment, control activities, and monitoring. Information and communication consists of the quality information management and personnel communicate and use to support the internal control system.
Information system	A discrete set of information resources organized for the collection, processing, maintenance, use, sharing, dissemination, or disposition of information.
Information system controls	Internal controls that are dependent on information systems processing and include general controls (entity-wide, system, and application levels), application controls (input, processing, output, master file, interface, and data management system controls), and user controls (controls performed by people interacting with information systems).
Information system controls auditor	A person with technical expertise in information technology systems, general controls, applications, and information security. This person is involved with the planning, directing, or performing of audit procedures related to assessing information system controls.
Information system processing	Processing performed by information systems through the use of information technology.
Information technology specialist	A person possessing special skills or knowledge in the information technology field that extend beyond the skills and knowledge normally possessed by those working in specialized fields of auditing, such as information system controls auditing.
Inherent risk	The susceptibility of an assertion about a line item, account, note disclosure, or class of transactions to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.
Inherent risk factors	Characteristics of events or conditions that affect the susceptibility to misstatement, whether due to fraud or error, of an assertion about a line item, account, note disclosure, or class of transactions, before consideration of controls. Such factors may be qualitative or quantitative and include complexity, subjectivity, change, uncertainty, susceptibility to noncompliance, or susceptibility to misstatement due to management bias or other fraud risk factors insofar as they affect inherent risk.

Integrated audit	An audit of internal control over financial reporting that is integrated with an audit of financial statements
Intent letter	A letter used by some auditors to acknowledge a congressional request for any type of work.
Inter-entity	Activity and balances occurring between federal entities that are trading partners. Inter-entity and intra-entity amounts comprise intragovernmental activity and balances.
Internal audit function	A function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance, risk management, and internal control processes.
Internal control	A process effected by an entity's oversight body, management, and other personnel that provides reasonable assurance that the objectives of the entity will be achieved.
Internal control over financial reporting	A process effected by those charged with governance, management, and other personnel. Internal control over financial reporting is a subset of the entity's internal control, and its objectives are to provide reasonable assurance that (1) transactions are properly recorded, processed, and summarized to permit the preparation of financial statements in accordance with U.S. generally accepted accounting principles, and assets are safeguarded against loss from unauthorized acquisition, use, or disposition, and (2) transactions are executed in accordance with provisions of applicable laws, including those governing the use of budget authority, regulations, contracts, and grant agreements, noncompliance with which could have a material effect on the financial statements.
Internal control phase	Entails understanding, testing, and assessing internal control over financial reporting to reach conclusions about the reliability of financial reporting and compliance with significant provisions of applicable laws, regulations, contracts, and grant agreements.
Internal control system	A continuous built-in component of operations, effected by people, that provides reasonable assurance—not absolute assurance—that an entity's objectives will be achieved.
Intra-entity	Activity and balances occurring within a federal entity. Intra-entity and inter-entity amounts comprise intragovernmental activity and balances.

Intragovernmental amounts	Activity and balances occurring within a federal entity (i.e., intra-entity) or between federal entities (i.e., inter-entity).
Intragovernmental Payment and Collection (IPAC) system	The primary method used by most federal entities to electronically bill or pay for services and supplies within the U.S. government. IPAC is used to communicate between the Treasury and the trading partner entities that the online billing or payment for services and supplies has occurred.
Judgment fund	A permanent and indefinite appropriation administered by the Department of the Treasury that is available to pay judgments, settlement agreements, and certain types of administrative awards against the United States when such payment is not otherwise provided for in entity appropriations.
Judgmental misstatement	Misstatements arising from the judgments of management, including those concerning recognition, measurement, presentation, and disclosure in the financial statements (including the selection or application of accounting policies) that the auditor considers unreasonable or inappropriate.
Limit	Used in performing substantive analytical procedures, the limit is the amount of difference between the expected and the recorded amount that the auditor will accept without investigation.
Limitation	A restriction on the amount, purpose, or period of availability of budget authority. While limitations are most often established through appropriations acts, they may also be established through authorization legislation. Limitations may be placed on the availability of funds for program levels, administrative expenses, direct loan obligations, loan guarantee commitments, or other purposes.
Line item risk analysis (LIRA)	An audit document that contains the auditor's identification and assessment of risks of material misstatement at the assertion level for material line items, accounts, note disclosures, and classes of transactions. It includes, at the assertion level, the assessed level of inherent risk; identification of significant risks; assessed level of control risk and risk of material misstatement; and the planned nature, extent, and timing of substantive audit procedures.
Logical unit	The balance or transaction that includes the selected dollar in a monetary unit sample.

Management	The persons with executive responsibility for the conduct of the entity's operations. For some entities, management includes some or all of those charged with governance, for example, senior executives.
Management's point estimate	The amount selected by management for recognition or disclosure in the financial statements as an accounting estimate. U.S. GAAP may require disclosure of a range of possible outcomes.
Management's specialists	Individuals or organizations possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist in preparing the financial statements.
Material weakness	A deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. (Also see control deficiency and significant deficiency.)
Materiality	For purposes of the audit, misstatements, including omissions, are considered to be material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements. Note that FASAB's Statement of Federal Financial Accounting Concepts (SFFAC) 1, *Objectives of Federal Financial Reporting*, provides a slightly different definition of materiality. Since SFFACs are nonauthoritative and in SFFAC 1, the board recognizes differences from the audit definition, the FAM is based on the definition provided in AU-C 200.07. (Also see materiality for the financial statements as a whole, performance materiality, and tolerable misstatement.)
Materiality benchmark	The element of the financial statements that the auditor judges is most significant to the primary users of the statements. The basis for which materiality is calculated.
Materiality for the financial statements as a whole	The auditor's preliminary estimate of materiality in relation to the financial statements as a whole, primarily based on quantitative measures. It is used to determine performance materiality, which in turn is used to determine tolerable misstatement. These are then used to determine the risks of material misstatement and the nature, extent, and timing of substantive audit procedures. It is also used to identify significant

	provisions of applicable laws, regulations, contracts, and grant agreements for compliance testing.
May, might, or could	See degree of compliance.
Misappropriation of assets	Theft of an entity's assets causing misstatements in the financial statements.
Misstatement	A difference between the reported amount, classification, presentation, or disclosure of a financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be presented fairly in accordance with U.S. GAAP. Misstatements can arise from fraud or error. (Also see factual misstatement, judgmental misstatement, and projected misstatement.) Misstatements also include those adjustments of amounts, classifications, presentations, or disclosures that, in the auditor's professional judgment, are necessary for the financial statements to be presented fairly, in all material respects.
Misstatement of fact	Other information that is unrelated to matters appearing in the audited financial statements that is incorrectly stated or presented. A material misstatement of fact may undermine the credibility of the document containing audited financial statements.
Modified opinion	A qualified opinion, an adverse opinion, or a disclaimer of opinion.
Monetary unit sampling	A variables sampling method that uses a probability proportional to size (PPS) sample selection technique.
Monitoring	One of the five components of internal control, in addition to control environment, entity risk assessment, control activities, and information and communication. Monitoring consists of activities management establishes and operates to assess the quality of performance over time and promptly resolve the findings of audits and other reviews.
Multipurpose testing	Performing several tests, such as control tests, compliance tests, and substantive tests, on a single selection, usually a statistical sample.
Must	See degree of compliance.
Net cost approach	An approach used to evaluate misstatements. This approach quantifies a misstatement with the objective of making the current year statement of net cost correct.

Noncompliance	Acts of omission or commission by the entity, either intentional or unintentional, which are contrary to the prevailing laws, regulations, contracts, or grant agreements. Such acts include transactions entered into by, or in the name of, the entity or on its behalf by those charged with governance, management, or employees. Noncompliance does not include personal misconduct (unrelated to the business activities of the entity) by those charged with governance, management, or employees of the entity.
Nonrecognized events	Subsequent events that provide evidence with respect to conditions that did not exist at the date of the financial statements but arose subsequent to that date.
Nonstatistical sampling	A sampling approach to draw conclusions about a population that does not have all the characteristics of statistical sampling (see statistical sampling). The two principal techniques of selecting a nonstatistical sample are the use of random selection or haphazard selection. A nonstatistical sample is representative of, but not statistically projectable to, the population.
Nonstatistical selection	A selection of items for substantive testing to reach a conclusion only on the items selected. A nonstatistical selection is not representative of, nor statistically projectable to, the portion of the population that was not tested. Accordingly, the auditor applies appropriate analytical and/or other substantive procedures to the remaining items, unless those items are immaterial in total or the auditor has already obtained enough assurance that there is a low risk of material misstatement in the total population. The auditor may also use nonstatistical selection to test controls. Similar to nonstatistical selection for substantive testing, the auditor may not project the results of nonstatistical selection for control testing to the portion of the population not tested. To determine whether sufficient evidence has been obtained to conclude on the effectiveness of the controls tested, the auditor considers the results of the nonstatistical selection in conjunction with other sources of evidence.
Note disclosures	Individual elements of information that are reported in a note to the financial statements.
Notification letter	A letter used by some auditors to notify an entity of new engagements for any type of work.

Obligation (budgetary obligation)	OMB Circular No. A-11, *Preparation, Submission, and Execution of the Budget,* defines obligation as a binding agreement that will result in outlays, immediately or in the future. GAO's Federal Budget Glossary (GAO-05-734SP) defines obligation as a definite commitment that creates a legal liability of the government for the payment of goods and services ordered or received, or a legal duty on the part of the United States that could mature into a legal liability by virtue of actions on the part of the other party beyond the control of the United States. Payment may be made immediately or in the future. An agency incurs an obligation, for example, when it places an order, signs a contract, awards a grant, purchases a service, or takes other actions that require the government to make payments to the public or from one government account to another.
Office of the General Counsel (OGC)	The office advises the auditor in (1) identifying significant provisions of applicable laws and regulations to test; (2) identifying budget restrictions; and (3) identifying and resolving legal issues encountered during the financial statement audit, such as evaluating potential instances of noncompliance.
Offsetting receipts and collections authority	Statutory authority that permits federal entities to obligate and expend the proceeds of offsetting receipts and collections. Offsetting receipts and collections are of a business-market-oriented nature and may include intragovernmental transactions, such as reimbursements for materials or services provided to other government entities. If, pursuant to law, they are credited to appropriations or fund expenditure accounts and are available for obligation without further congressional action, they are referred to as offsetting collections.
Operations controls	A process by management and others, designed to provide reasonable assurance regarding the achievement of objectives for the planning, productivity, quality, economy, efficiency or effectiveness of operations.
Other auditors	Auditors other than the audit organization performing the entity's financial statement audit as group auditor. These other auditors may be part of the entity's monitoring controls.
Other information	Financial or nonfinancial information (other than the financial statements, supplementary information, required supplementary information, and auditor's report) included in an entity's annual report.

Other-matter paragraph	A paragraph included in the auditor's report that is required by U.S. GAAS, or is included at the auditor's discretion, and that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's professional judgment, is relevant to users' understanding of the audit, the auditor's responsibilities, or the auditor's report.
Overall analytical procedures	Analytical procedures performed as an overall financial statement review during the reporting phase.
Overall audit strategy	An audit document that sets the scope, timing, and direction of the audit and guides the development of the audit plan. In establishing the overall audit strategy, the auditor should • identify the characteristics of the engagement that define its scope; • ascertain the reporting objectives of the engagement in order to plan the timing of the audit and the nature of the communications required; • consider the factors that in the auditor's professional judgment, are significant in directing the engagement team's efforts; and • ascertain the nature, timing, and extent of resources necessary to perform the engagement.
Performance and accountability report (PAR)	The PAR consists of the information in the AFR (see agency financial report above) and performance information required for most federal executive agencies.
Performance materiality	The amount or amounts set by the auditor as a portion of materiality that the auditor allocates to particular line items, accounts, classes of transactions (such as disbursements), or note disclosures.
Planning phase	The objectives of this audit phase are to gain an understanding of the entity to be audited; to understand its environment, including internal control; to identify significant areas for audit; and to design effective and efficient audit procedures.
Population	The entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.
Precision (allowance for sampling risk)	A measure of the difference between a sample estimate (projection) and the tolerable rate of deviation or tolerable misstatement at a specified sampling risk.

Preliminary analytical procedures	Analytical procedures performed during the audit planning phase.
Presentation and disclosure	Financial and other information in the financial statements is appropriately aggregated or disaggregated and clearly described. Note disclosures are appropriately measured and described and are relevant and understandable in the context of the requirements of U.S. GAAP. All note disclosures that should have been included in the financial statements have been included. Disclosed transactions and events have occurred and pertain to the entity.
Principal statements	See financial statements.
Probable	Generally, in evaluating a loss contingency, the future confirming event or events are more likely than not to occur. In evaluating a loss contingency for pending or threatened litigation and unasserted claims, the future confirming event or events are likely to occur.
Professional judgment	The application of relevant training, knowledge, and experience, within the context provided by auditing, accounting, and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement.
Professional skepticism	An attitude that includes a questioning mind, being alert to conditions that may indicate possible misstatement due to fraud or error, and a critical assessment of audit evidence.
Projected misstatement	The auditor's best estimate of the amount of the misstatements in populations, involving the projection of misstatements identified in audit samples to the entire population from which the samples were drawn.
Providing entity	The entity providing services, products, goods, transfer funds, investments, debt, and/or incurring the reimbursable costs. This includes bureaus, departments, and/or programs within entities. The providing agency is the seller. The providing entity transfers out funds to another entity (transfers out) when appropriations are transferred without the exchange of goods or services.
Public-private partnerships	Risk-sharing arrangements or transactions lasting more than 5 years between public and private sector entities.

Random sample	A sample selected so that every combination of the same number of items has an equal probability of selection.
Ratio estimation	A classical variables sampling technique that uses the ratio of audited amounts to recorded amounts in the sample to estimate the total dollar amount of the population and an allowance for sampling risk.
Reasonable assurance	In the context of an audit of financial statements, a high, but not absolute, level of assurance.
Reasonably possible	In evaluating a loss contingency, the chance of the future confirming event or events occurring is more than remote but less than probable. In assessing inherent risk for identified risks of material misstatement at the assertion level, the likelihood of a material misstatement occurring is more than remote.
Receiving entity	The entity receiving services, products, goods, transfer funds, purchasing investments, and/or borrowing from Treasury (or other entities). This includes bureaus, departments, and/or programs within entities. The receiving entity is the purchaser. The receiving entity receives transfers of funds (transfers in) when appropriations are transferred without the exchange of goods or services.
Reciprocal accounts	Corresponding *U.S. Standard General Ledger* (USSGL) accounts that should be used by a providing/seller and receiving/buyer entity to record like intragovernmental transactions. For example, the providing entity's accounts receivable would normally be reconciled to the reciprocal account, accounts payable, on the receiving entity's records.
Recognized events	Subsequent events that provide additional evidence with respect to conditions that existed at the date of the financial statements and affect the estimates inherent in the process of preparing the financial statements, notes, and RSI.
Recorded amount	The financial statement amount being tested by the auditor in the specific application of substantive tests.
Regression estimate	An estimate of a population parameter for one variable that is obtained by substituting the known total for another variable into a regression equation calculated on the basis of sample values of the two variables. Ratio estimates are special kinds of regression estimates.

Reimbursable activity	An intragovernmental activity in which the entity receiving goods or services reimburses the providing entity in accordance with an agreed-upon price, which may or may not represent fair value.
Related parties	Under FASAB standards, organizations are considered to be related parties in the general purpose federal financial report if the existing relationship or one party to the existing relationship has the ability to exercise significant influence over the other party's policy decisions. Relationships and transactions between the entity and other federal entities (intragovernmental) are not considered related party relationships and transactions. Given the similarity of risks, related parties, as used in auditing standards, include disclosure entities, related parties, and public-private partnerships, as these terms are defined by FASAB.
Relevant controls or relevant control activities	Effectively designed controls or control activities the auditor plans to test, that if implemented and operating effectively, would achieve specific control objectives that address identified risks of material misstatement. "Relevant control activities" as used in the FAM are referred to as identified controls or controls that address the risks of material misstatement at the assertion level in AU-C 315.
Remote	In evaluating a loss contingency, the chance of the future confirming event or events occurring is slight. In assessing inherent risk for identified risks of material misstatement at the assertion level, the auditor believes that the likelihood of a material misstatement occurring in the assertion is less than reasonably possible.
Reporting phase	This phase completes the audit based on the results of audit procedures performed in the preceding phases. This involves developing the auditor's report on the entity's (1) financial statements, RSI (including MD&A), and other information included in the annual report; (2) internal control over financial reporting; (3) financial management systems' substantial compliance with the three FFMIA requirements (for CFO Act agencies); and (4) compliance with significant provisions of applicable laws, regulations, contracts, and grant agreements.
Report release date	The date the auditor grants the entity permission to use the auditor's report in connection with the financial statements. Often, this will be the date the auditor provides the audit report to the entity. The report release date will ordinarily be a date that is close to the auditor's report date.

Required supplementary information (RSI)	Information that a designated accounting standards setter requires to accompany an entity's basic financial statements. RSI is not part of the basic financial statements; however, a designated accounting standards setter considers the information to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. In addition, authoritative guidelines for the methods of measurement and presentation of the information have been established.
Responsibility segment	A significant organizational, operational, functional, or process component that has the following characteristics: (1) its manager reports to the entity's top management, (2) it is responsible for carrying out a mission, performing a line of activities or services, or producing one or a group of products, and (3) for financial reporting and cost management purposes, its resources and results of operations can be clearly distinguished, physically and operationally, from those of other segments of the entity.
Reviewer (engagement quality control reviewer or second partner)	A person who is not part of the engagement team and has sufficient and appropriate experience and authority to objectively evaluate the significant judgments that the engagement team made and the conclusions it reached in formulating the auditor's report.
Rights and obligations	The entity holds or controls the rights to assets, and liabilities are the obligations of the entity, at a given date. The entity has rights to budgetary resources, and budgetary obligations pertain to the entity, at a given date (see budgetary resources and obligation).
Risk	See audit risk, inherent risk, control risk, risk of material misstatement, and detection risk.
Risk assessment procedures	The audit procedures designed and performed to obtain audit evidence that provides an appropriate basis for (1) the identification and assessment of risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels and (2) the design of further audit procedures, consisting of control and substantive tests.
Risk of material misstatement	The risk that prior to the audit, the financial statements are materially misstated due to fraud or error. The components of risk of material misstatement are inherent risk and control risk. (Also see inherent risk and control risk.)

Safeguarding controls	Internal controls to protect assets from loss from unauthorized acquisition, use, or disposition of entity assets that could have a material effect on the financial statements.
Sample	See audit sample.
Sampling	See audit sampling.
Sampling interval	An amount between two consecutive sample items in a systematic sample. The sampling interval is determined by dividing the number of items in the population by the desired number of selections. When used in the context of a systematic sample used to select items for monetary unit sampling (MUS), it is the tolerable misstatement divided by the statistical risk factor.
Sampling risk	The risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. For tests of controls, sampling risk is the risk of assessing control risk either too low or too high. For substantive testing, sampling risk is the risk of incorrect acceptance or the risk of incorrect rejection.
Sampling unit	Any of the individual elements, as defined by the auditor, that constitute the population.
Sequential sampling	A sampling plan for which the sample is selected in several steps, with each step conditional on the results of the previous steps.
Service auditor	A practitioner who reports on controls at a service organization.
Service organization	An organization or segment of an organization that provides services to other entities that are relevant to those entities' internal control over financial reporting.
Should	See degree of compliance.
Significant assertion	An assertion about a line item, account, note disclosure, or class of transactions that has one or more identified risks of material misstatement for which inherent risk is more than remote. "Significant assertion" as used in the FAM is referred to as relevant assertion in AU-C 315. (Also see assertions, identified risk of material misstatement, and inherent risk.)
Significant deficiency	A deficiency, or a combination of deficiencies, in internal control over financial reporting, that is less severe than a material weakness yet important enough to merit

	attention by those charged with governance. (Also see control deficiency and material weakness.)
Significant risk	An identified risk of material misstatement • for which the assessment of inherent risk is high; • due to fraud for which inherent risk is more than remote; or • arising from transactions with disclosure entities, related parties, and public-private partnerships that are also significant unusual transactions, for which inherent risk is more than remote.
Significant unusual transactions	Significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual due to their timing, size, or nature.
Special Investigator Unit	The unit investigates specific allegations involving conflict-of-interest and ethics matters, contract and procurement irregularities, official misconduct and abuse, and fraud in federal programs or activities. In the offices of the IGs, this is the investigation unit; at GAO, it is the Forensic Audits and Investigative Service team. The Special Investigator Unit provides assistance to the auditor by (1) informing the auditor of relevant pending or completed investigations of the entity and (2) investigating possible instances of fraud, waste, and abuse.
Special purpose entity	An entity created for a specific, limited, and normally temporary purpose. A special purpose entity can be a corporation, trust, partnership, limited liability company, or some type of variable interest entity. Special purpose entities are often an integral part of public-private partnerships because of their risk-containment nature of isolating participating entities from financial risk.
Specific control evaluation (SCE)	An audit document that contains the auditor's evaluation of the effectiveness of specific control activities in achieving the control objectives.
Statistical sampling	A sampling approach to draw conclusions about a population that has the following characteristics: • random selection of the sample items and • the use of an appropriate statistical technique to evaluate sample results, including measurement of sampling risk, to project the results to the population. A sampling approach that does not have these characteristics is considered nonstatistical sampling.

Stewardship land	Land and rights owned by the federal government but not acquired for or in connection with items of general PP&E.
Stratification	The process of dividing a population into subpopulations, each of which is a group of sampling units that have similar characteristics. Stratification may be used to focus procedures on risk areas or to reduce variability in sampling populations.
Subsequent events	Events or transactions that affect the financial statements, notes, or RSI that may occur or become known between the date of the financial statements and the date of the auditor's report.
Subsequently discovered facts	Facts that become known to the auditor after the date of the auditor's report that, had they been known to the auditor at that date, may have caused the auditor to revise the auditor's report.
Substantive analytical procedures	The comparison of a recorded amount with an expectation of that amount and subsequent investigation of any significant differences to reach a conclusion on the recorded amount.
Substantive audit assurance	The auditor's judgment about the probability that all substantive tests of an assertion will detect aggregate misstatements that exceed materiality. Not the same as confidence level.
Substantive procedures or tests	Audit procedures designed to detect material misstatements at the assertion level. Substantive procedures comprise tests of details and substantive analytical procedures.
Sufficiency (of audit evidence)	The measure of the quantity of audit evidence. The quantity of the audit evidence necessary is affected by the auditor's assessment of the risks of material misstatement and the quality of the audit evidence obtained (that is, its appropriateness).
Suitable criteria	In agreed upon procedures engagements or other attestation engagement engagements, standards for acceptability which have the attributes of objectivity, measurability, completeness, and relevance.
Supplemental analytical procedures	Analytical procedures to increase the auditor's understanding of account balances and transactions when detail tests are used as the sole source of substantive assurance.

Supplementary information	Information presented outside the financial statements and RSI, for which the auditor is engaged to report on whether such information is fairly stated, in all material respects, in relation to the financial statements as a whole. Supplementary information is not considered necessary for the financial statements to be fairly presented in accordance with U.S. GAAP. Such information may be presented in a document containing the audited financial statements or separate from the financial statements.
Sustainability financial statements	The sustainability financial statements are the • statement of long-term fiscal projections (at the government-wide consolidated level only), • statement of social insurance, and • statement of changes in social insurance amounts. The sustainability financial statements are based on projections of future receipts and spending.
Systematic random sampling	A method of selecting a sample in which every *n*th item is selected using one or more random starts. When the first item is selected using judgment from the interval, the method is termed systematic sampling.
Testing phase	The objectives of this audit phase are to (1) obtain reasonable assurance about whether the financial statements are presented fairly, in all material respects, in accordance with U.S. GAAP; (2) determine whether the entity complied with significant provisions of applicable laws, regulations, contracts, and grant agreements; and (3) assess the effectiveness of internal control over financial reporting through testing controls often in coordination with other tests.
Those charged with governance (oversight body)	Those who have the responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity, including overseeing the entity's financial reporting process. For a federal entity, those charged with governance may be members of a board or commission, an audit committee, the secretary of a cabinet-level department, or senior executives and financial managers responsible for the entity.
Tolerable misstatement	The application of performance materiality to a particular substantive sampling procedure. Tolerable misstatement is defined in AU-C 530.05 as a monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the

	monetary amount set by the auditor is not exceeded by the actual misstatement in the population.
Tolerable rate of deviation	The maximum rate of deviations from the prescribed control that the auditor is willing to accept without altering the preliminary control risk. This is also referred to as tolerable error, tolerable rate, or tolerable deviation.
Trading partner code	Assigned by the U.S. Department of the Treasury, trading partner codes are used to facilitate the preparation of the *Financial Report of the United States Government*.
Trading partners	Federal entities that request or provide transactions and transfers between federal entities.
Transfers	Shifting of all or part of the budget authority in one appropriation or fund account to another. Entities may transfer budget authority only as specifically authorized by law. For accounting purposes, the nature of the transfer determines whether the transaction is treated as an expenditure or a nonexpenditure transfer.
***Treasury Financial Manual* (TFM)**	The *Treasury Financial Manual* (TFM) is Treasury's official publication of policies, procedures, and instructions concerning financial management in the federal government. It is intended to promote the government's financial integrity and operational efficiency.
Type 1 Report	Report on the fairness of the presentation of management's description of the service organization's system and the suitability of the design of the controls to achieve the related control objectives included in the description as of a specified date. Type 1 reports focus on controls likely to be relevant to entities' internal control over financial reporting.
Type 2 Report	Report on the fairness of the presentation of management's description of the service organization's system and the suitability of the design and operating effectiveness of the controls to achieve the related control objectives included in the description throughout a specified period. Type 2 reports focus on controls likely to be relevant to entities' internal control over financial reporting.
Uncorrected misstatements	Misstatements that the auditor has accumulated during the audit and that have not been corrected.

Undelivered orders	The value of goods and services ordered and obligated that have not been received. This amount includes any orders for which advance payment has been made but for which delivery or performance has not yet occurred.
Universe	See population.
Unliquidated obligation	The amount of outstanding obligations or liabilities.
U.S. generally accepted accounting principles (U.S. GAAP)	The U.S. accounting principles that are promulgated by a standard setter approved by the AICPA. SFFAS 34 contains the hierarchy of accounting standards for financial statements of federal government entities. The standards issued by FASAB are the first level of the hierarchy. For government corporations and certain other entities, the standards issued by FASB are the first level of the hierarchy.
***U.S. Standard General Ledger* (USSGL)**	A uniform chart of accounts and guidance for standardizing U.S. federal accounting. Composed of five major sections: (1) chart of accounts, (2) accounts and descriptions, (3) account transactions, (4) USSGL attributes, and (5) USSGL crosswalks to standard external reports. Prescribed by the Department of the Treasury in its *Treasury Financial Manual.*
***U.S. Standard General Ledger* (USSGL) at the transaction level**	One of the three requirements of FFMIA. Implementing the USSGL at the transaction level means that transactions are recorded in full compliance with the USSGL Chart of Account's descriptions and posting models/attributes that demonstrate how the USSGL is to be used for recording transactions of the federal government accounting process; reports produced by the systems provide financial information, whether used internally or externally, that can be traced directly to the USSGL accounts; and transactions from feeder systems, which may be summarized and interfaced into the core financial system's general ledger, are posted following USSGL requirements.
User controls	Controls that are performed by people interacting with IS controls. The effectiveness of user controls typically depend on the accuracy of the information produced by the IS controls.
Walk-throughs	Audit procedures to help the auditor understand the design of controls and whether they have been implemented. They may also provide some evidence of control effectiveness. Walk-throughs of financial reporting controls include tracing one or more transactions from initiation, through all processing, to inclusion in the general ledger; observing the processing

and applicable controls in operation; making inquiries of personnel applying the controls; and inspecting related documents.

OTHER GLOSSARIES

NOTE 1 The *Federal Information System Controls Audit Manual* (FISCAM) contains a glossary of information systems terms (see GAO-09-232G, February 2009).

NOTE 2 *A Glossary of Terms Used in the Federal Budget Process* contains additional terms and definitions (see GAO-05-734SP, September 2005).

NOTE 3 The AICPA's *Audit Sampling Guide* contains a glossary of terms.

NOTE 4 The Federal Accounting Standards Advisory Board's *Handbook of Federal Accounting Standards and Other Pronouncements, as Amended* contains a glossary of terms.

Abbreviations

AFR	agency financial report
AICPA	American Institute of Certified Public Accountants
AT-C	AICPA's *Standards for Attestation Engagements [Clarified]*
AU-C	AICPA's *Auditing Standards [Clarified]*
BETC	business event type code
CARS	Treasury's Central Accounting Reporting System
CFO	chief financial officer
CFO Act	Chief Financial Officers Act of 1990
CIGIE	Council of the Inspectors General on Integrity and Efficiency
FAM	GAO/CIGIE *Financial Audit Manual*
FASAB	Federal Accounting Standards Advisory Board
FASB	Financial Accounting Standards Board
FBWT	fund balance with Treasury
FFMIA	Federal Financial Management Improvement Act of 1996
FISCAM	*Federal Information System Controls Audit Manual*
FISMA	Federal Information Security Modernization Act of 2014
FMFIA	31 U.S.C. § 3512(c), (d), commonly known as the Federal Managers' Financial Integrity Act of 1982
GAGAS	generally accepted government auditing standards (also known as the Yellow Book)
GASB	Governmental Accounting Standards Board
Green Book	*Standards for Internal Control in the Federal Government*
IDEA	Interactive Data Extraction and Analysis
IG	inspector general
IS	information system (when referring to IS controls or IS controls auditor)
LIRA	line item risk analysis
MD&A	management's discussion and analysis
MUS	monetary unit sampling (also known as dollar unit sampling)
NIST	National Institute of Standards and Technology

OGC	Office of the General Counsel
OMB	Office of Management and Budget
PAR	performance and accountability report
PIIA	Payment Integrity Information Act of 2019
PPS	probability proportional to size
RSI	required supplementary information
SCE	specific control evaluation
SFFAS	Statement of Federal Financial Accounting Standards
SSAE	Statement on Standards for Attestation Engagements
SUM	summary of uncorrected misstatements
TAS	Treasury account symbol
TFM	*Treasury Financial Manual*
U.S. GAAP	U.S. generally accepted accounting principles
U.S. GAAS	U.S. generally accepted auditing standards
U.S.C.	United States Code or U.S. Code
USSGL	*U.S. Standard General Ledger*
Yellow Book	generally accepted government auditing standards (GAGAS)

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