AICPA
Governmental Audit Quality Center
Member Event

Single Audit Fundamentals Part III:
Understanding and Testing Compliance Requirements and Related Internal Control over Compliance

March 11, 2010

Administrative Notes

• If you encounter any technical difficulties (e.g., audio issues) during this event please take the following steps:
  – Press the F5 key on your computer
  – Re-start your browser
  – Check your speakers, ensure they are not on mute
  – Turn off your pop-up blocker
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  – Call Genesys Tech support 866.814.1918, Conf ID# 1439281
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• If are unable to get assistance from Genesys for some reason, e-mail gaqc@aicpa.org or call 202-434-9207
Administrative Notes

- We encourage you to submit your technical questions – please limit your questions to the content of today’s program.
- To submit a question, type it into the “Send a Question” box on left side of your screen; we will answer as many as possible.
- You can also submit questions to the GAQC member forum for consideration by other members.
- This event is being recorded and will be posted in an archive format to the GAQC Web site.

Continuing Professional Education

- Must have registered for CPE credit prior to this event; the CPE Credit Approval Form was e-mailed to you.
- Listen for announcement of 4 CPE codes (7 digit codes: ALL______) and 4 polling questions during the event.
- Record CPE Codes on CPE Credit Approval Form and return completed form (by fax or mail) to AICPA Service Center for record of attendance; keep a copy for your records.
- If you are not receiving CPE for this call, ignore the CPE codes that we announce, but please answer the polling questions.
Single Audit Fundamentals Series
Sponsored by the GAQC

• What is GAQC?
  – Voluntary membership Center for CPA firms and State Audit Organizations (SAOs), with approximately 1,400 members
  – Designed to help CPAs meet the challenges of performing quality governmental audits, including single audits
  – Member benefits/membership requirements
  – For more information, please visit the membership section at www.aicpa.org/GAQC or call Cynthia Dillon at 202-434-9207

A Note on the Recovery Act

• In February 2009, the American Recovery and Reinvestment Act of 2009 (ARRA) was passed
  • Approximately $300 billion additional federal funds being passed down; much of which is subject to single audits
  • Recovery Act does have implications on testing compliance as there are new compliance requirements for certain programs
  • Today’s call is focusing on understanding and testing compliance and related internal control over compliance in general
  • A future GAQC event (not yet scheduled) will provide additional information on the Recovery Act, including effects on understanding and testing compliance and related internal control over compliance
  • Review the GAQC Recovery Act Resource Center (www.aicpa.org/GAQC) for previous calls and guidance issued
Today’s Presenters

Diane Edelstein, CPA
Maher Duessel, CPAs

Kim McCormick, CPA
Grant Thornton LLP

Moderator
Corey Arvizu, CPA
Heinfeld, Meech Co., PC
Chair, GAQC Executive Committee

Single Audit Fundamentals
Fundamentals Courses

- Part I – Basic Background & Overview of the Single Audit
  - Scope of the Single Audit
  - Auditee & Auditor Responsibilities
  - Unique Requirements & Provisions of OMB Circular A-133
  - Description & Characteristics of Federal Awards
  - Pass-through Awards and Subrecipients
- Part II – Understanding Major Program Determination
  - Applying the Risk-Based Approach for Determining Major Programs
  - Low-Risk Auditee Determination and Distinguishing from Other Risk Assessments Performed in a Single Audit
  - Communications with Cognizant or Oversight Agency

Fundamentals Courses

- Part III - Understanding Compliance Testing & IC over Compliance Requirements
  - Description & Characteristics of the 14 Compliance Requirements
  - Description & Characteristics of Internal Control over Compliance
  - Substantive Tests of Applicable Compliance Requirements
  - Tests of Internal Control over Compliance
  - Documentation Requirements
  - Introduction to and Using the Annual OMB Compliance Supplement
Fundamentals Courses

• Part IV - Reporting Requirements and an Overview of Available Circular A-133 Resources (March 18, 2010, from 1:00pm – 3:00pm Eastern)
  – Reporting Requirements of the Single Audit
  – Overview and Use of the AICPA Audit Guide Government Auditing Standards and Circular A-133 Audits and Audit Risk Alert
  – Understanding the OMB Cost Circulars and their Applicability to Audit Procedures
  – Use of www.cfda.gov and other Web Sites to Facilitate a Single Audit

TOPICS to be COVERED

• Overview of the 14 Compliance Requirements
• Compliance Testing
• Internal Control Testing
• Documentation Requirements
• Purpose & Use of the OMB Compliance Supplement
Federal Awards and Compliance Requirements

Overview of 14 Compliance Requirements

- Activities Allowed or Unallowed
- Allowable Costs/Cost Principles
- Cash Management
- Davis Bacon Act
- Eligibility
- Equipment and Real Property Management
- Matching, level of effort, earmarking
- Period of Availability
- Procurement, Suspension and Debarment
- Program Income
- Real Property Acquisition and Relocation Assistance
- Reporting
- Subrecipient Monitoring
- Special Tests and Provisions
Overview of 14 Compliance Requirements

- Activities Allowed or Unallowed (A)
  - Specifies the activities that can or cannot be funded under a specific program

- Allowable Costs / Cost Principles (B)
  - Specifies the costs that can and cannot be funded under a specific program and how they are calculated and supported

- Cash Management (C)
  - Reimbursements are properly supported
  - Advance payments are properly managed
  - Interest earned on advance payments is inconsequential or remitted to grantor

- Davis-Bacon Act (D)
  - Contractors are paid the prevailing wages of the local department of labor
Overview of 14 Compliance Requirements

- Eligibility (E)
  - Participants meet the program criteria to receive grant funding

- Equipment and Real Property Management (F)
  - Management, use and disposal of equipment or real property

- Matching Level of Effort Earmarking (G)
  - Matching, required cost share
  - Level of effort, required participation from period to period
  - Earmarking, setting aside funding for a purpose

- Period of Availability of Federal Funds (H)
  - Expenditures are within the granting period
  - Claims have been made within a reasonable period of time after the granting period
Overview of 14 Compliance Requirements

- Procurement and Suspension and Debarment (I)
  - Federal, state or local procurement laws are followed
  - Vendors and sub-recipients are not suspended or debarred

- Program Income (J)
  - Income generated by Federal funds are used for program expenditures
  - Income generated by Federal program offset Federal claims

- Real Property Acquisition and Relocation Assistance (K)
  - Equal treatment by persons displaced by the Federal government

- Reporting (L)
  - Reporting results
    - Performance
    - Financial
    - Special reporting
Overview of 14 Compliance Requirements

• Sub-recipient Monitoring (M)
  – Monitoring pass-through funding

• Special Tests (N)
  – Other

Example – Allowable Costs/Cost Principles (A/B)

• To be allowable, a cost must:
  – Be reasonable for the performance of the award and be allocable in accordance with A-122, A-87 or A-21
  – Conform to any limitations or exclusions set forth in A-122, A-87 or A-21
  – Be consistent with policies and procedures that apply uniformly to both federally financed and other activities of the organization
  – Be accorded consistent treatment
  – Be determined in accordance with GAAP
  – Not be included as a cost of any other federally financed program (or used to meet matching requirements)
  – Be adequately documented
  – Be net of all applicable credits
Example – Allowable Costs/Cost Principles (A/B)

- Allowable Costs – Direct Costs

  - Direct costs are those that can be identified specifically with a particular final cost objective

    - Certain direct costs are allowable for computing charges to Federal awards and must be allocated their share of indirect costs if they represent activities that a) include salaries, b) occupy space, c) benefit from the organization’s indirect costs

<table>
<thead>
<tr>
<th>Selected Cost Item</th>
<th>Under OMB Circular A-122</th>
</tr>
</thead>
<tbody>
<tr>
<td>Advertising/Public Relations</td>
<td>Allowable with restrictions</td>
</tr>
<tr>
<td>Alcoholic Beverages</td>
<td>Unallowable</td>
</tr>
<tr>
<td>Bad Debt</td>
<td>Unallowable</td>
</tr>
<tr>
<td>Communications</td>
<td>Allowable</td>
</tr>
<tr>
<td>Donations and contributions</td>
<td>Unallowable</td>
</tr>
<tr>
<td>Depreciation and use</td>
<td>Allowable with specification</td>
</tr>
<tr>
<td>Entertainment</td>
<td>Unallowable with qualifier</td>
</tr>
<tr>
<td>Fines and penalties</td>
<td>Unallowable with exception</td>
</tr>
<tr>
<td>Labor relations</td>
<td>Allowable</td>
</tr>
<tr>
<td>Lobbying</td>
<td>Unallowable with exceptions</td>
</tr>
<tr>
<td>Maintenance/repair</td>
<td>Allowable with restrictions</td>
</tr>
</tbody>
</table>
Selected Cost Item | Under OMB Circular A-122
--- | ---
Meetings/Conferences | Allowable with restrictions
Pension plans | Allowable with restrictions
Professional services | Allowable with restrictions
Rent of building/equip | Allowable with restrictions
Selling and marketing | Unallowable with exceptions
Taxes | Allowable with restrictions
Training and education | Allowable with limitations
Travel costs | Allowable with restrictions

Group Check

Among the 14 compliance requirements, which would you guess are among the most likely to be applicable to a federal award?
Overview of 14 Compliance Requirements

- Activities Allowed or Unallowed
- Allowable Costs/Cost Principles
- Cash Management
- Davis Bacon Act
- Eligibility
- Equipment and Real Property Management
- Matching, level of effort, earmarking
- Period of Availability
- Procurement, Suspension and Debarment
- Program Income
- Real Property Acquisition and Relocation Assistance
- Reporting
- Subrecipient Monitoring
- Special Tests and Provisions

Governmental Audit Quality Center
Overview of 14 Compliance Requirements

- Form and extent of documentation of auditee’s compliance with major program requirements will vary
  - Accounting data
  - Statistical data
  - Case files
  - Policy and procedure manuals
  - Narrative memoranda
  - Calculations

TOPICS to be COVERED

- Overview of the 14 Compliance Requirements
- Compliance Testing
- Internal Control Testing
- Documentation Requirements
- Purpose & Use of the OMB Compliance Supplement
Excerpts from Auditor’s OMB A-133 Report

Compliance

“...we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred.”

AND

“In our opinion, NPO complied, in all material respects, with the requirements that are applicable to each of its major federal program for the year ended June 30, 2009.”

Compliance Testing – Back to Basics

• Financial statement audit
  – Testing focused on financial statement assertions

• Compliance audit
  – Testing focused on adherence to direct and material compliance requirements for major programs
Compliance Testing

• Determine **applicability** of compliance requirements
  – Part 2 of Compliance Supplement (CS) – Matrix of Compliance Requirements
  – Review contracts and grant agreements
  – Discuss with appropriate individuals within auditee organization

Part 2 – Matrix of Compliance Requirements

| CFDA | A | B | C | D | E | F | G | H | I | J | K | L | M | N | O | P | Q | R | S | T | U | V | W | X | Y | Z |
| 10.318 | 1 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| 10.317 | 1 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| 10.214 | 1 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| 10.313 | 1 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| 10.312 | 1 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| 10.311 | 1 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| 10.310 | 1 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |

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Compliance Testing

Among applicable compliance requirements, identify direct and material compliance requirements

- Direct and material effect means that noncompliance could result in being denied reimbursement of program expenditures or having to refund federal monies or make other restitution in an amount that would be material to the major program
- Qualitative and quantitative considerations

Direct and Material – Qualitative Aspects

- Needs and expectations of federal or pass-through agencies
- Noncompliance could cause Federal agency to take action
  - Seeking reimbursement of program costs
  - Suspending participation in the program
- Public or political sensitivity
Direct and Material – Quantitative Aspects

- Noncompliance could likely result in questioned costs

- Requirement affects large part of the program
  - Material amount of program dollars

- Materiality assessments
  - Example: X% of expenditures, +/- 1 day, etc

Compliance Testing

- Direct and material compliance requirements will be tested

- Audit objectives and suggested audit procedures in Compliance Supplement
TOPICS to be COVERED

• Overview of the 14 Compliance Requirements
• Compliance Testing
• **Internal Control Testing**
• Documentation Requirements
• Purpose & Use of the OMB *Compliance Supplement*

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Excerpts from Auditor’s OMB A-133 Report

**Internal Control Over Compliance**

“In planning and performing our audit, we considered NPO’s internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance…”
Internal Control - Back to Basics

• Financial statement audit
  – Focused on design effectiveness of controls surrounding financial statement assertions with reasonably possible risks of material misstatement

• Compliance audit
  – Focused on design and operating effectiveness of controls surrounding direct and material compliance requirements for major programs

Internal Control over Compliance

• Each major program
• Each direct & material compliance requirement
• Each of the 5 elements of COSO
• OMB A-133 says to plan testing of internal control to support low level of control risk
COSO - Five Interrelated Components

1. Control environment
2. Risk assessment
3. Control activities
4. Information communication
5. Monitoring

Control Environment

- The control environment is the foundation for the internal control system
- Three elements that significantly impact the quality of the control environment:
  - Management’s philosophy and operating style
  - Integrity and ethical values
  - Commitment to competence
Risk Assessment

- Establish objectives
- **Risk** - any condition, event, or factor that might prevent the organization from achieving its objectives
- Categories include operational, financial, and compliance

Control Activities and Monitoring

- When risks are known, **control activities** are established to either prevent or detect risks
- **Monitoring** mechanisms established to receive and evaluate output of control activities
Information and Communication

- Information is disseminated through channels of communication in the organization

Activities Allowed & Allowable Costs

Internal Control COSO Components

Control Environment
- Management sets reasonable budgets - minimize incentives to miscode expenditures

Risk Assessment
- Management has sufficient understanding of procedures and controls to identify unallowable activities
Activities Allowed and Allowable Costs

Internal Control COSO Components

Control Activities
- Program managers approve purchase orders or invoices prior to payment

Information and Communication
- Comparison of budget to actual is provided to project managers for review on a timely basis

Monitoring
- Financial reports are provided to appropriate management on periodic basis for review

Internal Control Testing
- Test of design and implementation
  - Walkthrough our understanding
  - Conclusion: Control has been properly designed and implemented
- Test of effectiveness
  - Test key control attributes
  - Conclusion: Control is effective
- Control must be effective or you should have a finding
Possible outcomes

• Deficiency?
• Significant deficiency?
• Material weakness?
• Need to expand compliance testing?
• Achievement of low control risk for some or all direct and material compliance requirements

Tests of Key Controls (operating effectiveness)

• Tests of internal control over compliance could include:
  - Inquiries of appropriate personnel
  - Inspection of documents and reports
  - Observation of the application of specific controls
  - Reperformance of the application of the controls
Process vs. Control

Processes
- Procedures that originate, transfer or change data
- Can introduce errors

Controls
- Procedures designed to prevent, detect and correct errors resulting from processing of accounting information
- Cannot generate errors

Example
- Process
  - Employees complete their timesheets

- Control
  - Project manager approves timesheets
  - Project manager approves invoices
Process or Control

1. Departmental reports are totaled and compared to total payroll report from general ledger by Payroll Administrator
2. The A/P Manager marks those invoices to be paid through check run in “Cash Requirements Report”
3. Travel expense and reimbursement forms date stamped by A/P clerk when received from Project Administrators

Control vs. Compliance testing

- Control test: What did they do to make sure the grant’s objective was attained?
- Compliance test: Was the grant’s objective attained?
- Consider dual-purpose testing
Part 6: Compliance Supplement – Internal Control

- Guidance not a checklist
- Facilitates discussions with management

TOPICS to be COVERED

- Overview of the 14 Compliance Requirements
- Compliance Testing
- Internal Control Testing
- Documentation Requirements
- Purpose & Use of the OMB Compliance Supplement
Documentation Requirements

• Review SAS No. 117 (new AICPA compliance auditing standard) – it says you should document:
  – The risk assessment procedures performed, including those relating to gaining an understanding of internal control over compliance
  – Responses to the assessed risk of material noncompliance, the procedures performed, and the results of those procedures, including any test of controls over compliance
  – Materiality levels and the basis for which they were determined
  – How complied with the specific governmental audit requirements that are supplementary to GAAS and Government Auditing Standards

• Keep in mind that you need to meet overall documentation requirements of SAS No. 103 and Government Auditing Standards—“the experienced auditor concept”

• New sampling chapter in the GAS/A-133 Audit Guide includes additional documentation considerations
GAQC Practice Aids

• Internal Control Practice Aids developed by GAQC
  – Will assist in illustrating appropriate documentation
  – In final production phase currently
  – GAQC members will receive an Alert when issued
  – Others will be able to purchase the Practice Aids
• GAQC members can access an archived call on Internal Control Considerations in a Single Audit that discusses the Practice Aids
  – See GAQC Web site at:
    http://gaqc.aicpa.org/Resources/Archived+GAQC+Conference+Calls.htm

TOPICS to be COVERED

• Overview of the 14 Compliance Requirements
• Compliance Testing
• Internal Control Testing
• Documentation Requirements
• Purpose & Use of the OMB Compliance Supplement
Purpose & Use of the OMB Compliance Supplement

- OMB Compliance Supplement issued annually
- 2009 Compliance Supplement is available at [http://www.whitehouse.gov/omb/grants_circulars/](http://www.whitehouse.gov/omb/grants_circulars/)
  - Appendix V lists changes made from previous year – You should review in detail
- OMB working on 2010 Compliance Supplement; final expected in April or May 2010
  - Will include program updates, as well as updated information on effect of the Recovery Act
  - Again, Appendix V will summarize changes made

Using the Compliance Supplement–

- Use all parts (2, 3, 4, 5, 6 and 7) for a correct Single Audit
  - 2: Matrix of Compliance Requirements
  - 3: Compliance Requirements
  - 4: Agency Program Requirements
  - 5: Clusters of Programs
  - 6: Internal Control
  - 7: Guidance for Auditing Programs not Included in the Compliance Supplement
- Use the correct year's supplement and watch for addenda
Using the Compliance Supplement –

• Part 2: Matrix of Compliance Requirements
  – Which compliance requirements are generally applicable
  – Define applicability
    • Discuss program with appropriate members of management
    • Possibly review contracts and grants
  – Determine which compliance requirements are direct & material

Using the Compliance Supplement –

Practice Aids & Tips

• Part 2: Matrix of Compliance Requirements
• Tips
  • Use professional judgment
  • Assess each major program individually
  • Consider both quantitative and qualitative materiality
  • DOCUMENT determination why an applicable requirement is NOT deemed direct & material
    N/A or NOT Direct & Material not enough
Using the Compliance Supplement –
Current Requirements & Practice Aids and Tips

• Part 3: Compliance Requirements
  • Generic compliance requirement information
  • Generic audit procedures

• Tips
  • Refrain from using the Compliance Supplement as a checklist
  • Understand the various programs to determine whether modifications to the audit approach are necessary

Using the Compliance Supplement

• Parts 4 (Agency Program Requirements) and 5 (Clusters of Programs)
  • Program specific compliance regulation information
  • Limited program specific audit procedures
  • Potential impact of ARRA on Clusters

• Tips
  • Cannot be used without parts 2 and 3
  • Cannot be your audit program
Using the Compliance Supplement –
Current Requirements

• Part 6: Internal Control
  – Internal control considerations for each compliance requirement for each major program

• Tips
  – Not intended as checklist

Using the Compliance Supplement

• Part 7: Guidance for Auditing Programs not Included
  – Guidance for identifying the applicable compliance requirements for programs not included in the Supplement

• Tips
  – Will assist the auditor in answering the following questions:
    1. What are the program objectives, program procedures, and compliance requirements for a specific program?
    2. Which of the compliance requirements could have a direct and material effect on the program?
    3. Which of the compliance requirements are susceptible to testing by the auditor?
    4. Into which of the 14 types of compliance requirements does each compliance requirement fall?
    5. For Special Tests and Provisions, what are the applicable audit objectives and audit procedures?
Using the Compliance Supplement –

• Bookmark the OMB site that catalogs the various years’ Compliance Supplements
  – http://www.whitehouse.gov/omb/grants_circulars/
  – Understand your entity to make the proper modifications to the generic steps presented within the CS
• Refrain from using the CS as a checklist
• GAQC Risk Matrix Practice Aid will be useful

RECAP: TOPICS COVERED TODAY

• Overview of the 14 Compliance Requirements
• Compliance Testing
• Internal Control Testing
• Documentation Requirements
• Purpose & Use of the OMB Compliance Supplement
To Register for Final Web Event

- If you haven’t already registered for the final Web event in this GAQC series (next Thursday) but would like to do so:
  - GAQC members, refer to GAQC Alert #138
  - Non-GAQC members, refer to e-mail invitation you received
  - Any questions—e-mail gaqc@aicpa.org

- Archived versions of Part I and II are currently available to members on www.aicpa.org/GAQC
  - Non-GAQC members can send a request to access the archives at: gaqc@aicpa.org