Single Audit Fundamentals Part 3: Understanding and Testing Compliance Requirements and Related Internal Control over Compliance

A Governmental Audit Quality Center Web Event
Today’s speakers

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Single Audit Fundamentals – A Four Part Series

Part 1, What is a Single Audit? A Basic Background and Overview

Part 2, The Mysteries of Major Program Determination

Part 3, Understanding and Testing Compliance Requirements and Internal Control over Compliance

Part 4, Overview of Sampling and Single Audit Reporting
What we will cover

Introduction to and using the annual OMB Compliance Supplement

Determining direct and material compliance requirements using the OMB Compliance Supplement

*Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards at 2 CFR 200* (UG or Uniform Guidance) requirements for testing internal controls

Understanding and testing the compliance requirements

Documentation requirements
<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
<th>Source</th>
</tr>
</thead>
<tbody>
<tr>
<td>A/P</td>
<td>Accounts Payable</td>
<td>Green Book</td>
</tr>
<tr>
<td>AU-C</td>
<td>Reference to section number for clarified Statements on Auditing Standards in AICPA Professional Standards</td>
<td>OMB Office of Management and Budget</td>
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<tr>
<td>CFDA</td>
<td>Catalog of Federal Domestic Assistance</td>
<td>PTE Pass-Through Entity</td>
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<td>COSO</td>
<td>“Internal Control Integrated Framework,” issued by the Committee of Sponsoring Organizations of the Treadway Commission</td>
<td>SEFA Schedule of Expenditures of Federal Awards</td>
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<td>FAC</td>
<td>Federal Audit Clearinghouse</td>
<td>SFA Student Financial Assistance</td>
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<tr>
<td>GAS-SA Guide</td>
<td>AICPA Audit Guide, Governmental Auditing Standards and Single Audits</td>
<td>Supplement OMB Compliance Supplement</td>
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<tr>
<td>G/L</td>
<td>General Ledger</td>
<td>UG Uniform Guidance</td>
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The OMB Compliance Supplement
Purpose and use of the Supplement

Supplement issued annually

Current Supplement is available at:


• Bookmark this Web address
What is the Supplement?

Identifies the existing important compliance requirements that the federal government expects to be considered as part of a single audit.

One of the most important pieces of guidance that you use in performing single audits.

Provides a source of information for auditors to understand federal program objectives, procedures, and compliance requirements.

Includes audit objectives and suggested audit procedures for determining compliance with the noted requirements.
Use all parts of the Supplement correctly

1. Matrix of Compliance Requirements
2. 3.1 and 3.2: Compliance Requirements
3. Agency Program Requirements
4. Clusters of Programs
5. Internal Control
6. Guidance for Auditing Programs not Included in the Supplement

Don’t forget Appendices
Using the Supplement - Part 2: Matrix of Compliance Requirements

Auditors use Part 2 to determine compliance requirements

Part 2 indicates which compliance requirements are generally applicable

Auditor determines actual applicability
  – Discuss program with appropriate members of management
  – Possibly review contracts and grants

Auditor then determines which compliance requirements are direct and material
Using the Supplement – Part 2 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 and material

- N/A or “NOT Direct and Material” not enough
Using the Supplement - Part 3: Compliance Requirements

Generic compliance requirement information

Generic audit procedures

Tips
  - Refrain from using the Supplement as a checklist
  - Understand the various programs to determine whether modifications to the audit approach are necessary
Using the Supplement - Part 4: Agency Program Requirements, and Part 5: Clusters of Programs)

Include program-specific compliance regulation information

Limited program specific audit procedures

Tips

- Parts 4 and 5 cannot be used without parts 2 and 3
- Part 4 cannot be your audit program
Using the Supplement – Part 6: Internal Control

Describes UG requirements for internal control
Good source of guidance for auditor in this area
Using the Supplement - Part 7: Guidance for Auditing Programs Not Included

Provides guidance for identifying the applicable compliance requirements for programs not included in the Supplement

Will assist the auditor in answering the following questions:

• What are the program objectives, program procedures, and compliance requirements for a specific program?
• Which of the compliance requirements could have a direct and material effect on the program?
• Which of the compliance requirements are susceptible to testing by the auditor?
• Into which of the 12 types of compliance requirements does each compliance requirement fall?
• For Special Tests and Provisions, what are the applicable audit objectives and audit procedures?
Using the Supplement – key Appendices

Appendix III, Federal Agency Single Audit, Key Management Liaison and Program Contacts

Appendix V lists changes made from previous year – review in detail

Appendix VII provides Other Audit Advisories – review in detail
Determining direct and material compliance requirements using the OMB Compliance Supplement
Determining direct and material compliance requirements

Obtain an understanding of each major program

- Discuss program with appropriate members of management
- Review contracts and grant documents
  - Determine key elements
    - Amount
    - Timing
    - Applicable compliance requirements
    - Indirect cost considerations
    - Regulations
- Look at expenditure patterns
  - Wages, benefits, equipment, etc.
<table>
<thead>
<tr>
<th>12 Compliance Requirements in Part 2</th>
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<tbody>
<tr>
<td>A - Activities Allowed or Unallowed</td>
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<td>B - Allowable Costs/Cost Principles</td>
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<td>C - Cash Management</td>
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<td>D - Reserved</td>
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<td>E - Eligibility</td>
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<td>F - Equipment and Real Property</td>
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<td>Management</td>
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<td>G - Matching, Level of Effort, and</td>
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<td>Earmarking</td>
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<td>H - Period of Performance</td>
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<td>I - Procurement and Suspension and</td>
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<td>Debarment</td>
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<td>J - Program Income</td>
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<td>K - Reserved</td>
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<td>L - Reporting</td>
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<td>M - Subrecipient Monitoring</td>
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<td>N - Special Tests and Provisions</td>
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Determine applicability using Part 2 Matrix
Which compliance requirements are generally **applicable**?

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A note about Part 2 and applicability

“Y” may appear in matrix, even though a requirement may not apply to a particular entity

• Entity may not have activity subject to the compliance requirement; or
• Activity could not have a material effect on major program

Auditor should exercise professional judgment when determining which compliance requirements marked with a “Y” need to be tested at a particular entity

Documentation is key if overriding a “Y”
What is “direct and material effect?”

Direct and material effect means:

• Noncompliance could result in being denied reimbursement of program expenditures; or

• Entity having to refund federal monies or make other restitution in an amount that would be material to the major program
Determining direct and material compliance requirements

Which applicable compliance requirements are **direct and material**?

- Subjective
  - Auditor judgment
  - Experience
  - Accepted risk
  - Industry expectation
- Use information gained from steps taken to obtain an understanding of each major program at the outset (see slide 18)
- Qualitative and quantitative factors
Determining direct and material compliance requirements – qualitative factors

<table>
<thead>
<tr>
<th>Needs and expectations of federal or PTEs</th>
<th>Suspending participation in the program</th>
</tr>
</thead>
<tbody>
<tr>
<td>Noncompliance could cause federal agency to take action</td>
<td>Public or political sensitivity</td>
</tr>
<tr>
<td>Seeking reimbursement of program costs</td>
<td>Federal, state, local oversight</td>
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<td></td>
<td>Internal or other external audits</td>
</tr>
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<td></td>
<td>Previous findings</td>
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</table>
Determining direct and material compliance requirements – quantitative factors

Noncompliance could likely result in questioned costs

Requirement affects large part of the program

Material amount of program dollars
  • For example, 5% of expenditures
  • Not an auditee concept
Compliance testing documentation – avoiding the “N/A” problem

“N/A” is not enough to support why you did not audit a type of compliance requirement

If your teams believe a requirement that is identified as being applicable to a program in the Part 2 matrix of the Compliance Supplement is not direct and material to a client, documentation should always be provided

**Documentation is key if overriding a “Y” in the Part 2 matrix!**
Example “N/A” documentation

Example 1. Detail testing of the subrecipient monitoring compliance requirement is not performed for CFDA XX.XXX even though the requirement is noted as applicable in the Part 2 matrix. This is because XYZ entity’s expenditure of program funds has not included passing funds down to subrecipients.

Example 2. While the Part 2 Matrix identifies procurement as being applicable to CFDA No. XX.XXX, Client ABC made only one small purchase during the year that is immaterial overall to the program expenditures. Therefore, the procurement type of compliance requirement for CFDA No, XX.XXX is not direct and material to Client ABC.

Example 3. Detail testing of the eligibility type of compliance requirement not performed. While the requirement is noted as applicable in the Part 2 matrix, the Compliance Supplement section for CFDA No. XX.XXX notes that testing eligibility is the responsibility of the pass-through entity’s subrecipients. Thus, it is to be tested by the auditors of Client ABC’s subrecipients.
Determining direct and material compliance requirements

Do auditors test all applicable compliance requirements?

• No; only test compliance requirements that could have a “direct and material effect”

Should an auditee comply with all applicable compliance requirements?

• Yes!
Uniform Guidance requirements for testing internal controls
The non-federal entity must establish and maintain effective internal control over the federal award that provides reasonable assurance that the non-federal entity is managing the federal award in compliance with federal statutes, regulations, and the terms and conditions of the federal award.

Internal controls should be in compliance with guidance in:

- “Standards for Internal Control in the Federal Government” (Green Book) issued by the Comptroller General of the United States, or
- the “Internal Control Integrated Framework”, issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Use of “should” in Uniform Guidance indicates a “best practice” and is not a presumptively mandatory requirement.
Auditors must perform procedures to obtain an understanding of internal control over federal programs sufficient to plan the audit to support a **low assessed level of control risk** of noncompliance for major programs.

Plan testing of internal control over the relevant compliance requirements for each major program

Perform testing of internal control as planned

Report on internal control over compliance (covered in Part 4 of series)
Internal Control – AICPA standards

AU-C 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, identifies 5 interrelated components that provide useful framework for auditors when considering internal control

- Control environment
- Risk assessment
- Information and communication systems
- Control activities
- Monitoring

These five components are the same as those found in both the Green Book and the COSO integrated framework
Considering internal control over compliance in a single audit

Auditor obtains an understanding of the **five components of internal control** sufficient to assess the risks of material noncompliance

Focus on **direct and material compliance requirements** for **each major program**
Example: “Activities Allowed or Unallowed” and “Allowable Costs/Cost Principles”

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

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

Control Activities
• Program managers approve purchase orders/invoices prior to payment

Monitoring
• Financial reports provided to appropriate management on periodic basis for review
COSO: 5 Components and 17 Principles of Effective Internal Control

1. Demonstrates commitment to integrity and ethical values
2. Exercises oversight responsibility
3. Establishes structure, authority and responsibility
4. Demonstrates commitment to competence
5. Enforces accountability

6. Specifies suitable objectives
7. Identifies and analyzes risk
8. Assesses fraud risk
9. Identifies and analyzes significant change

10. Selects and develops control activities
11. Selects and develops general controls over technology
12. Deploys through policies and procedures

13. Uses relevant information
14. Communicates internally
15. Communicates externally

16. Conducts ongoing and/or separate evaluations
17. Evaluates and communicates deficiencies

Control Environment
Risk Assessment
Control Activities
Information & Communication
Monitoring Activities
The standards in the Green Book are organized by the five components of internal control shown in the cube below. Each of the five components contains several principles. Principles are the requirements of each component.
Internal control over compliance – design and implementation versus effectiveness

Test of design and implementation

• Walkthrough auditor understanding
• Conclusion: Control has been properly designed and implemented

Test of operating effectiveness

• Test key control attributes
• Conclusion: Control is effective

If control not effective, a finding should be reported
Internal control over compliance - operating effectiveness

Tests of operating effectiveness different than determining that control has been implemented

Evidence of who, when, what

Procedures include:

• Inquiries
• Inspection of documents indicating performance
• Observation of application of specific controls
• Reperformance of controls by auditor

Generally involves combination of procedures

• Inquiry alone is not sufficient
Internal control over compliance - operating effectiveness

Test controls

- Throughout the period under audit
- Every period under audit

Internal controls that cross major programs

- Are they really the same?
- Representative sample
Internal control over compliance - operating effectiveness

Evaluating results of tests of controls

• Deviations may occur
  – Understand deviation and consequences
  – Determine if the expansion of the sample would provide evidence of containment of the error
  – Assess the deviation and determine proper reporting
    – Control deficiency
    – Material weakness
    – Significant deficiency
  – Assess impact on tests of compliance
Internal control over compliance - 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
Internal control over compliance - process vs. control – Do you get it?

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

✔ Process  ❌ Control
Understanding and testing the compliance requirements
Compliance – auditor responsibility

Must determine whether auditee complied

- With federal statutes, regulations, and the terms and conditions of federal awards that may have a direct and material effect on each of its major programs

Must determine the current compliance requirements and modify the audit procedures accordingly

- For the compliance requirements contained in the Supplement, an audit of these compliance requirements will meet the requirements of UG

Compliance testing must include tests of transactions and such other auditing procedures necessary to provide the auditor sufficient appropriate audit evidence to support opinion on compliance
A walk-through of the 12 compliance requirements

A- Activities Allowed/Unallowed

• Identifies what activities or projects can (or cannot) be funded under a specific program.

B - Allowable Costs/Cost Principles

• Describes the cost accounting requirements associated with federal awards

• Includes requirements for indirect costs

• Includes requirements for compensation – personal services
Indirect costs

Federal agencies have to accept a non-federal entity’s negotiated indirect cost rate unless statute or regulation allows for an exception or agency head approves.

Non-federal entities have option to extend rate for up to four years (one-time extension with some caveats).

Non-federal entities that have never received negotiated rate will be permitted to charge a de minimis rate of 10% of modified total direct costs which may be used indefinitely.

- Must be used consistently for all federal awards until entity chooses to negotiate for a rate.

§ 200.412-.415
Compensation – personal services

Requirements for:
- Existence of employees
- Reasonableness of compensation
- Assignment and allocation to federal awards

Time and distribution records must be maintained for all employees whose salary is:
- Paid in whole or in part with federal funds
- Used to meet a match/cost share requirement

Not based on budget estimates alone – needs to be ACTUAL

Full disclosure
- All time worked for the organization and what percentage is federal
Activities Allowed/Unallowed and Allowable Costs - testing compliance – discussion

How would we test compliance with these requirements?
A walk-through of the 12 compliance requirements

C - Cash Management

• When funded on a reimbursement basis, program costs must be paid for by entity funds before reimbursement is requested.

• When funds are advanced, recipients must follow procedures to minimize the time elapsing between the transfer of funds from the U.S. Treasury and disbursement.

• Interest earned on advances by local government grantees and subgrantees is required to be submitted to the federal agency.

• Program income typically must be spent first.
Cash Management- testing compliance – discussion

How would we test compliance with these requirements?
A walk-through of the 12 compliance requirements

E – Eligibility

• Specifies the criteria for determining the individuals, groups of individuals, or subrecipients that can participate in the program and the amounts of assistance for which they qualify

• Eligibility of those participating in the program funded by the grant or contract rather than the eligibility of the primary recipient
Eligibility - testing compliance – discussion

How would we test compliance with these requirements?
A walk-through of the 12 compliance requirements

F - Equipment and Real Property Management

• Equipment and real property management provides standards for the use and disposition of equipment and real property purchased with federal funds.

• These requirements cover records and inventory management.

• Equipment means tangible personal property, including information technology systems having a useful life of more than one year and a per-unit cost which equals or exceeds the lesser of the capitalization level established by the non-federal entity for financial statement purposes or $5,000 (§200.33).

• Title vests with the non-federal entity.
Equipment and Real Property Management - testing compliance – discussion

How would we test compliance with these requirements?
A walk-through of the 12 compliance requirements

G - Matching, Level of Effort, Earmarking

• Matching is amount (or percentage) of grantee contributions or matching funds provided.

• Matching, or cost sharing, includes requirements to provide contributions (usually non-federal) of a specified amount or percentage to match federal awards.

• Matching may be in the form of allowable costs incurred or in-kind contributions (including third-party in-kind contributions).
A walk-through of the 12 compliance requirements

G - Matching, Level of Effort, Earmarking

• Level of effort is specified service or expenditure levels maintained from period to period.

• Level of effort may include provisions for funds to supplement and not supplant non-federal funding of services.

• Earmarking is minimum or maximum limits for specified purposes.

• Earmarking may relate to amounts or types of participants covered.
Matching, Level of Effort, Earmarking - testing compliance – panel discussion

How would we test compliance with these requirements?
A walk-through of the 12 compliance requirements

H – Period of Performance

• Time during which the non-federal entity may incur new obligations to carry out the work authorized under the federal award

• Only costs incurred during the specified period may be charged to the grant award

• Sometimes pre-award costs are approved

• Can sometimes be “carried over”
Period of Performance - testing compliance – discussion

How would we test compliance with these requirements?
A walk-through of the 12 compliance requirements

I - Procurement, Suspension & Debarment

• Procurement – States must use the same policies and procedures they use for procurements from their non-federal funds

• Procurement – Non-federal entities other than states, including those operating federal programs as subrecipients of States, must follow the procurement standards set at 2 CFR 200.318 through 20.326

• Suspension & Debarment - Non-federal entities are prohibited from contracting with or making subawards under covered transactions to parties that are suspended or debarred
1. Micro-Purchases
2. Small Purchases
3. Sealed Bids
4. Competitive Proposals
5. Sole Source

General Standards:
A. Documented Policies
B. Necessary
C. Full & Open Competition
D. Conflict of Interest
E. Documentation
   i. Cost & Price Analysis
   ii. Vendor Selection

§ 200.317 -.326

Procurement “Claw” Illustration
Period of Performance - testing compliance – discussion

How would we test compliance with these requirements?
A walk-through of the 12 compliance requirements

J - Program Income

Gross income earned by a non-federal entity that is directly generated by a supported activity or earned as a result of the federal award during the period of performance

Includes, but is not limited to income from:

- fees for services performed,
- the use or rental of real or personal property acquired under federal awards,
- the sale of commodities or items fabricated under federal awards
- License fees and royalties on patents and copyrights, and
- payments of principal and interest on loans made with federal awards
Program Income - testing compliance – discussion

How would we test compliance with these requirements?
A walk-through of the 12 compliance requirements

L – Reporting

Grant recipients are required to use standard financial reporting forms for submitting information to the federal awarding agency.

Many times these reports are required of state agencies who develop their own reports for sub-grantees (local governments).

Performance or special reports may be required.
Reporting - testing compliance –discussion

How would we test compliance with these requirements?
M – Subrecipient Monitoring

- Requires recipients to monitor the activities of subrecipients relative to their federal awards.

- An award recipient is responsible for:
  - At the time of the award, identifying to the subrecipient the federal award information and applicable compliance requirements.
  - Evaluating each subrecipient’s risk of noncompliance for purposes of determining the appropriate subrecipient monitoring related to the subaward.
  - Monitoring the subrecipient’s use of federal awards.
  - Ensuring that subrecipients expending $750,000 or more in federal awards are audited.
  - Evaluating the impact of subrecipient activities on the pass-through entity’s ability to comply with applicable federal regulations.
Reporting - testing compliance – discussion

How would we test compliance with these requirements?
A walk-through of the 12 compliance requirements

N- Special Tests and Provisions

• Additional requirements set forth by federal agency – see Part 4 of the Supplement

• Found in the statues, regulations, and the provisions of contracts or grant agreements pertaining to the program

• Not every federal program has special tests and provisions
Special Tests and Provisions - testing compliance – discussion

How would we test compliance with these requirements?
AU-C 935, *Compliance Audits*, states that the auditor 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 also need to meet overall documentation requirements of AU-C 230, *Audit Documentation and Government Auditing Standards*—“the experienced auditor concept”
Can an auditor meet their overall objectives and support the audit opinion without documenting their work?

Is a signoff on an audit program sufficient documentation of a detail test?

Can an auditor substitute oral explanation for documenting the nature, timing, extent and results of audit procedures necessary to support the audit opinion?
Audit Documentation

No, No, and No!!!!!

- Do the work
- Document the work
- Obtain sufficient appropriate audit evidence
Recap: Topics covered today

Determining direct and material compliance requirements using the OMB Compliance Supplement

Uniform Guidance Requirements for Testing Internal Controls

Understanding and testing the compliance requirements

Documentation requirements
Single audit-related information


OMB

• Access OMB Compliance Supplement Compliance Supplement
• Find various additional UG related documents

Access grant guidance at https://cfo.gov/grants/

• Access latest UG FAQ document (July 2017)

How to access internal control frameworks

COSO framework

• Available for purchase

• [Access information](#)

Green Book

• Available for free

• [Access Green Book](#)
About the GAQC – www.aicpa.org/GAQC

Provides resources (e.g., alerts, web events, tools, etc.)

Current areas of emphasis

- *Government Auditing Standards*
- Single audits
- Preparing for study on single audit quality

Even if not a member, GAQC Web site provides useful information for both auditors and auditees

- For example, [GAQC Auditee Resource Center](#)
GAQC single audit tools and aids

SEFA Practice Aids

• Auditor SEFA Practice Aid
• Auditee SEFA Practice Aid

Practice Issue Noted With Auditee Corrective Action
Plan and Summary Schedule of Prior Audit Findings

Tips for Auditors Implementing the Uniform Guidance in Single Audits

11 Tips for Success with Single Audits (Journal of Accountancy article)
Where to find more?

Access the following single audit-related GAQC archived web events

- **Single Audits: New Insights on Factors Driving Quality**
- **Uniform Guidance Year 3: A Deeper Dive into Challenging Audit Areas**
- **Uniform Guidance: Challenging Compliance Areas**
- **Internal Control: COSO, the Green Book, and More**

Note: There are numerous other archived Web events on UG and other topics at link above!
How Do I Get My CPE Certificate?

Access your CPE certificate by clicking the blue “CPE” icon

• If at the end of this presentation you are eligible for but unable to print your CPE certificate, please log back in to this webcast in 24 hours and click the blue “CPE” button. Your certificate will still be available.

• If you need assistance with locating your certificate, please contact the AICPA Service Center at 888.777.7077 or service@aicpa.org.
Thank you