SECTION 300

Internal Control Phase

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310 - OVERVIEW

.01 In the internal control phase, the auditor should gain an understanding of internal control and obtain evidence about the effectiveness of internal control to (1) assess control risk, (2) determine the nature, timing, and extent of control, compliance, and substantive testing, and (3) form an opinion or report on internal control over financial reporting and compliance. Control risk should be assessed separately for each significant financial statement assertion in each significant cycle/accounting application (including RSSI). (See figure 300.1.) The auditor also should gain an understanding of the components of internal control relating to the existence and completeness assertions (and valuation for GAO audits) (see definitions of assertions in paragraph 235.02) relevant to the performance measures reported in the MD&A (overview) of the Accountability Report in order to report on controls that have not been properly designed and placed in operation. The auditor is not required to test performance measures controls, but he or she may decide to do so.

.02 The entity's management is responsible for establishing and maintaining internal control 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 (also see paragraph 310.10 for the auditor's responsibility for performance measures controls):

- Reliability of financial reporting ("financial reporting controls")—transactions are properly recorded, processed, and summarized to permit the preparation of the financial statements and RSSI in accordance with generally accepted accounting principles, and assets are safeguarded against loss from unauthorized acquisition, use, or disposition;

- Compliance with applicable laws and regulations ("compliance controls")—transactions are executed in accordance with (a) laws governing the use of budget authority and other laws and regulations that could have a direct and material effect on the principal statements or RSSI, and (b) any other laws, regulations, and governmentwide policies identified by OMB in its audit guidance.

.03 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 during the period under audit. In addition, if the auditor intends to opine on internal control, he or she makes a separate conclusion on internal control as of the end of the period. Additionally, the auditor may test certain operations controls and should understand performance measures controls, as discussed in the planning phase (section 275).

.04 Internal control over safeguarding assets constitutes a process, effected by an entity's governing body, management, and other personnel, designed to provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements. As used in this manual, safeguarding controls, a part of financial reporting controls, relate to protecting assets from loss arising from misstatements in processing transactions and handling the related assets. Section 395 C includes a list of typical safeguarding controls. Safeguarding controls examined as part of a financial statement audit do not relate to the loss of assets arising from management's operating business decisions, such as incurring expenditures for equipment or material that might prove to be unnecessary. (Such controls are operations controls.) Safeguarding controls consist of (1) controls that prevent or detect unauthorized access (direct or indirect) to assets and (2) segregation of duties. Safeguarding controls are considered as part of financial reporting controls.

.05 Just as safeguarding controls are part financial reporting and part operations controls, budget controls are part financial reporting and part 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, mainly the statements of budgetary resources and financing, in accordance with 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.

.06 The auditor must evaluate and test certain controls. AU 319 (SAS 55 amended by SAS 78) permits the auditor to assess control risk at a high (maximum) level and forgo evaluation and testing of financial reporting controls if the auditor believes evaluating their effectiveness would be inefficient. However, because OMB audit guidance requires the auditor to perform sufficient tests of internal controls that have been properly designed and placed in operation to support a low assessed level of control risk, the auditor may <u>not</u> elect to forgo control tests solely because it is more efficient to extend compliance and substantive audit procedures.

.07 The following are the types of controls to test:

- **financial reporting controls** (including certain **safeguarding** and **budget controls**) for each significant assertion in each significant cycle/accounting application (identified in section 240),

- **compliance controls** for each significant provision of laws and regulations (identified in section 245), including **budget controls** for each relevant budget restriction (identified in section 250), and

- **operations controls** for each operations control (1) relied on in performing financial audit procedures or (2) selected for testing by the audit team. The auditor also should understand performance measures controls, but is not required to test them. However, the auditor may decide to test them (see section 275).

.08 The auditor is not required to test controls that have not been properly designed and placed in operation. Thus, internal controls that are not effective in design (or in operation, based on prior years' testing) do not need to be tested. If the auditor determined in a prior year that controls in a particular accounting application were ineffective and if management indicates that controls have not improved, the auditor need not test them. On the other hand, if controls have been determined to be effective in design and placed in operation, the auditor must perform sufficient tests of their effectiveness to support a low assessed level of control risk. In such cases, the auditor may consider using a rotation approach to testing controls over the various accounting applications, as described in section 395 G. If the auditor expects to disclaim an opinion because of scope limitations or inadequate controls, the auditor may limit internal control work to updating the understanding of controls and whether they have been placed in operation. 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 needs a basis of sufficient work on internal control.

.09 In the internal control phase, the auditor should perform and document the following procedures:

- Understand the entity's information systems for financial reporting, compliance with laws and regulations, and relevant operations (including reported performance measures) (see section 320).
- Identify control objectives (see section 330).
- Identify and understand relevant control activities that effectively achieve the control objectives (see section 340).
- Determine the nature, timing, and extent of control testing (not necessary for performance measures controls) (see section 350).
- Perform control tests that do not involve sampling (nonsampling control tests - see section 360).[1] (Sampling control tests, if necessary, are performed in the testing phase, as discussed in section 450.) Testing is not required for performance measures controls.
- On a preliminary basis, based on the evidence obtained, assess (1) the effectiveness of financial reporting, compliance, and relevant operations controls and (2) control and combined risk (see section 370). (Combined risk, which includes inherent and control risk, is discussed in paragraph 370.09).

.10 OMB's audit guidance also defines internal control over performance measures as a process, effected by management and other personnel, designed to provide reasonable assurance that the following objective is met:

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[1] The auditor should consider coordinating sampling control tests with substantive audit procedures and/or tests of compliance with laws and regulations (multipurpose tests) to maximize efficiency. See section 450 for further discussion.

- Reliability of performance reporting—transactions and other data that support reported performance measures are properly recorded, processed, and summarized to permit the preparation of performance information in accordance with criteria stated by management.

OMB requires the auditor to obtain an understanding of the components of internal control over performance measures included in the MD&A relating to the existence and completeness assertions (for GAO audits, the valuation assertion is also included in the understanding) and to report deficiencies in the design of those controls that have not been properly designed and placed in operation. Note that the auditor is not required to test internal control over performance measures.

.11 In gaining an understanding of an entity's internal control, the auditor should obtain knowledge about the design of relevant controls and whether they have been placed in operation. In obtaining knowledge about whether controls have been placed in operation, the auditor determines whether the entity is using them, rather than merely having them written in a manual, for example. This differs from determining a control's operating effectiveness, which is concerned with how the control was applied, the consistency with which it was applied, and by whom. Gaining an understanding of internal control does not require that the auditor obtain knowledge about operating effectiveness.

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320 - UNDERSTAND INFORMATION SYSTEMS

.01 The auditor should obtain an understanding of the entity's information systems (including methods and records) for processing and reporting accounting (including RSSI), compliance, and operations data (including performance measures reported in the MD&A (overview) of the Accountability Report).[1] The information systems are part of the information and communication component of internal control. The communication portion of this component was considered in section 260. The auditor should obtain sufficient knowledge of each type of system to understand the information in paragraphs 320.03-.07. The auditor may use an IS auditor to assist in understanding and documenting the IS aspects of these systems. The understanding of the systems should be documented in cycle memorandums or other narratives and flow charts.

.02 The auditor should perform sufficient system walkthroughs to confirm the understanding of significant information about such systems. However, if the auditor already has a sufficient understanding of the systems as a result of procedures performed in the preceding year, discussion of any system changes with management may be substituted for the walkthroughs. In a walkthrough of an accounting system, the auditor traces one or more transactions from initiation through all processing to inclusion in the general ledger, observing the processing in operation and examining related documents. Because walkthroughs are important in understanding the transaction process and in determining appropriate audit procedures, they should be performed for all significant accounting applications. Walkthroughs of budget accounting, compliance, and operations systems (including reported performance measures) should provide the auditor with evidence about the functioning of such systems. This walkthrough is to confirm the understanding of the system. The IS aspects of each system should be incorporated into the audit workpapers, supplemented by additional flow charts, narratives, and checklists, as considered necessary.

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1 As indicated in paragraphs 260.27-.31, the FMFIA report and its supporting documentation may be considered as a starting point for evaluating internal control. The auditor may use management's documentation of systems and internal control where appropriate. Management's tests of controls may be used by the auditor in testing controls, if such tests were executed by competent individuals independent of the controls. (See AU 322 (SAS 65) and section 650 for further information.)

ACCOUNTING SYSTEM(S)

.03 The auditor should obtain an understanding of and should document the following for each significant cycle and accounting application (including those dealing with RSSI):

- The manner in which transactions are initiated;
- The nature and type of records, journals, ledgers, and source documents, and the accounts involved;
- The 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; and
- The process used to prepare the entity's financial statements and budget information, including significant accounting estimates, disclosures, and computerized processing.

.04 Understanding the processing involved will be important in determining whether the financial management systems substantially comply with federal financial management systems requirements, federal accounting standards, and the SGL at the transaction level, so the auditor can report as required by FFMIA. If the entity is likely to receive an unqualified opinion and to have no material weaknesses in internal control, the auditor should test, (for efficiency, this could be done while performing nonsampling control tests (see section 350)), significant information the entity provides to support its assertion about the substantial compliance of its systems.

BUDGET ACCOUNTING SYSTEM(S)

.05 Through discussions with individuals responsible for accounting for budget execution, the auditor should understand and document the entity's process 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 (undelivered orders);
- Establishing and recording expended authority (delivered orders);

- Establishing and recording outlays;
- Monitoring supplemental appropriations;
- Recording transactions in and adjustments to expired accounts; and
- Monitoring canceled (closed) accounts.

COMPLIANCE SYSTEM(S)

.06 The compliance system includes the entity's policies and procedures to monitor overall compliance with laws and regulations applicable to the entity. Through discussions with entity management, the auditor should understand and document the entity's process for:

- Identifying and documenting all laws and regulations applicable to the entity;
- Monitoring changes in applicable laws and regulations and responding on a timely basis;
- Establishing policies and procedures for complying with specific laws and regulations and clearly documenting and communicating these policies and procedures to appropriate personnel;
- Assuring that an appropriate number of competent individuals at appropriate levels within the entity monitor the entity's compliance with applicable laws and regulations; and
- Investigating, resolving, communicating, and reporting any noncompliance with laws and regulations.

OPERATIONS SYSTEM(S) (INCLUDING REPORTED PERFORMANCE MEASURES)

.07 Through discussions with appropriate entity personnel, the auditor should understand and document any entity systems in which operations controls to be evaluated and tested operate, and any systems that produce the data used in performance measures reported in the MD&A (overview) of the Accountability Report. For example, if the auditor intends to evaluate and test an operations control that is dependent on certain statistical information, the auditor should understand how such statistical information is developed. Also, although the auditor is not required to test controls over a system producing data used in performance measures (unless it is an accounting or other system tested for other reasons), he or she should understand the system and the design of internal control related to the existence, completeness, and, for GAO audits, valuation (see definition in paragraph 235.02) assertions and whether they have been placed in operation. Thus, the auditor should understand and document the following:

- How the entity determines the performance measures to report, including their relationship to the entity's mission;
- The source of the information used in performance measures;
- The processing involved from the initial source information to its inclusion in performance measures; and
- The process used to prepare the performance measures from the system-produced data.

330 - IDENTIFY CONTROL OBJECTIVES

.01 The auditor should identify control objectives for each type of control that, if achieved, would provide the entity with reasonable assurance that misstatements (whether caused by error or fraud), losses, or noncompliance material in relation to the principal statements would be prevented or detected. For RSSI, 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. Such objectives should cover the following general areas:

- **Financial reporting controls:** Prevent or detect aggregate misstatements in significant financial statement assertions, including assertions relating to RSSI and the statements of budgetary resources and financing. Also, **Safeguarding controls:** Safeguard assets against loss from unauthorized acquisition, use, or disposition.

- **Compliance controls:** Comply with significant provisions of applicable laws and regulations. Also, **Budget controls:** Execute transactions in accordance with budget authority.

- **Operations controls:** For each relevant operations control, achieve the performance level desired by management for the planning, productivity, quality, economy, efficiency, or effectiveness of the entity's operations. For performance measures controls, report the data used to measure the entity's performance in accordance with criteria stated by management.

Paragraphs 330.02-.11 describe the process for identifying control objectives for each type of control.

FINANCIAL REPORTING CONTROLS

.02 The auditor should evaluate and test financial reporting controls for each significant assertion in each significant line item or account, including RSSI and the statements of budgetary resources and financing. (See paragraph 235.02 for a discussion of financial statement assertions.) The first step in developing control objectives for financial reporting controls is to consider the types of misstatements that might occur in each significant assertion in each significant line item or account. One or more potential misstatements can occur in each financial statement assertion. For example, for the existence or occurrence assertion, potential misstatements can occur in the following four areas:

- **Validity:** Recorded transactions do not represent economic events that actually occurred.

- **Cutoff:** Transactions are recorded in a different period from that in which the economic events occurred.

- **Summarization:** Transactions are summarized improperly, resulting in an overstated total.

- **Substantiation:** Recorded assets and liabilities of the entity do not exist at a given date.

For each potential misstatement, there are one or more control objectives that, if achieved, would prevent or detect the potential misstatement. These potential misstatements and control objectives provide the auditor the primary basis for assessing the effectiveness of an entity's control activities.

<u>Identifying Potential Misstatements and Control Objectives</u>

.03 As discussed in section 240, the auditor identifies the significant accounting applications that provide a source of significant entries to each significant line item or account. For example, as illustrated in section 395 A, (1) sources of significant entries to cash typically include the cash receipts, cash disbursements, payroll, and cash accounting applications, and (2) sources of significant entries to accounts receivable typically include the billing, cash receipts, and accounts receivable accounting applications. Such accounting applications should have been identified in the cycle matrix or ARA or equivalent documentation.

.04 The auditor should understand how potential misstatements in significant accounting applications could affect the related line item or account at an 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 understatement of accounts receivable (by overstating the credit to accounts receivable). To illustrate this concept using the assertions, a misstatement in the existence or occurrence assertion for cash receipts typically results in misstatements in (1) the existence or occurrence assertion for the cash account and (2) the completeness assertion for accounts receivable.

.05 The following general rules may be used to determine the effect of transaction-related accounting applications on line items/accounts:

Transaction-Related Accounting Application Assertion	Affected Line Item/Account Assertion
Existence or Occurrence	• Existence or occurrence, if the application increases the line item/account balance • Completeness, if the application decreases the line item account balance
Completeness	• Completeness, if the application increases the line item/account balance • Existence or occurrence, if the application decreases the line item/account balance
Valuation	• Valuation

.06 For each potential misstatement in the accounting application, the auditor should identify related control objectives that prevent or detect the potential misstatement. Section 395 B includes a list of potential misstatements that could occur in each assertion in an accounting application and related control objectives. The auditor should exercise judgment in determining which potential misstatements and control objectives to use. The list included in section 395 B should be tailored to the accounting application and to the entity and may be supplemented with additional objectives or subobjectives.

.07 If the above procedures were performed and documented by line item or account, a given application might be addressed two or more times. For example (see section 395 A), the purchasing accounting application typically would be addressed in evaluating controls relating to the inventory, property, liabilities, and expenses accounts. To avoid such duplication, the auditor should use a Specific Control Evaluation (SCE) worksheet or equivalent to document the procedures discussed in paragraphs 330.03-.06. The SCE groups potential misstatements and control objectives by accounting application (within each cycle), providing a format to perform and document the evaluation and testing of internal controls efficiently. See section 395 H for an example of a completed SCE worksheet. GAO has developed sample forms in WordPerfect and MS Word for preparing the ARA and SCE worksheets.

The Need for Testing Safeguarding Controls and Segregation-of-Duties Controls

.08 Safeguarding controls and segregation-of-duties controls are often critical to the effectiveness of controls over liquid (easily sold or traded), 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 are relevant. If the auditor determines that (1) the asset is highly liquid or marketable and (2) material amounts are susceptible to theft, loss, or misappropriation, the auditor should identify control objectives for safeguarding such assets and evaluate and test safeguarding controls. On the other hand, if the asset is not liquid or marketable or if material amounts are not readily susceptible to theft, loss, or misappropriation, the need to test safeguarding controls may be lessened. (Testing for segregation of duties is discussed in paragraphs 360.11-.12. Other safeguarding controls are considered in connection with financial reporting controls, as part of the existence assertion.)

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 statements of budgetary resources and financing in accordance with GAAP and (2) executes transactions in accordance with budget authority. Section 395 F presents a list of budget control objectives, organized by steps in the budget process. In addition, section 395 D presents a list of selected statutes relevant to the budget and section 395 E describes budget steps of interest to the auditor in evaluating an entity's budget controls. Budget control objectives may be documented in a separate SCE worksheet for budget controls, in a memo, or incorporated in an SCE 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 and regulations. Compliance control objectives should be tailored to the related provision and may be documented in a separate SCE worksheet for compliance controls, in a memo, or incorporated into an SCE 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 goals. The objective of performance measures controls is to provide reasonable assurance that the data that support performance measures reported in the MD&A (overview) of the Accountability Report are properly recorded and accounted for to permit the preparation of reliable and complete performance information. Operations control objectives should be tailored to the related provision and may be documented in a separate SCE worksheet for operations controls, in a memo, or incorporated into an SCE with related financial reporting controls.

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340 - IDENTIFY AND UNDERSTAND RELEVANT CONTROL ACTIVITIES

.01 For each control objective, based on discussions with entity personnel, the auditor should identify the control activities designed and implemented to achieve the specific control objective.[1] Such controls may be recorded in the auditor's informal notes and/or interview write-ups for use in the following procedure, but each control activity need not be formally documented on the SCE worksheet at this time. The auditor should first screen the activities to identify those that are effective and efficient to test. An IS auditor may assist the auditor in identifying and understanding IS controls.

BASIC UNDERSTANDING OF EFFECTIVENESS OF CONTROL ACTIVITIES

.02 The auditor should obtain a sufficient understanding of the identified control activities to determine whether they are likely to achieve the control objectives, assuming an effective control environment, risk assessment, communication, and monitoring, appropriate segregation of duties, and effective general controls. The purpose of this assumption is to identify any weaknesses in the specific control activities that should be corrected. When other internal control components are poor, there is inadequate segregation of duties, or poor general controls preclude the effectiveness of specific control activities that would otherwise be effective, the testing of such specific control activities may be limited to determining whether such controls are in place. To accomplish this, the auditor might (1) discuss the cycle and specific controls with management and then (2) perform walkthroughs by observing the controls in place or examining several items of documentary evidence of their existence.

FACTORS TO CONSIDER

.03 When evaluating whether controls are likely to achieve the control objectives, the factors that the auditor should consider include (1) directness, (2) selectivity, (3) manner of application, and (4) follow-up. In determining

[1] Section 395 C presents a list of typical control activities that an entity may establish to help prevent or detect misstatements in financial statement assertions.

whether control objectives are achieved, the auditor should consider both manual and IS controls, if likely to be effective (see section 270).

.04 **Directness** refers to the extent that 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 misstatements in the existence assertion for inventory than a periodic physical inventory, which is more directly related to the existence assertion.

.05 **Selectivity** refers to the magnitude of the amount, or the significance of other criteria or distinguishing characteristics, that a specific control 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 is likely to be effective, the auditor should consider 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 laws and regulations, or significant ineffective or inefficient use of resources. The auditor also should consider the appropriateness of the specified criteria used to identify items on 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.

.06 **Manner of application** refers to the way in which an entity places a specific control into operation. The manner of application can influence the effectiveness of a specific control. The auditor should consider the following factors when determining the effectiveness of controls:

- **Frequency of application:** This refers to the regularity with which controls are applied. Generally, the more frequently a control is applied, the greater the likelihood that it will be effective.

- **Experience and skills of personnel:** This refers to whether the person applying a control has the necessary knowledge and expertise to properly apply it. The lesser the person's experience and skills, the less likely that the control will be effective. Also, the effective application of a control is generally adversely affected if the technique (1) is performed by an employee who has an excessive volume of work or (2) is not performed carefully.

.07 **Follow-up** refers to the procedures followed when a control identifies an exception condition. A control's effectiveness is dependent on the effectiveness of follow-up procedures. To be effective, these procedures should be applied on a timely basis and should (1) determine whether control exceptions represent misstatements and (2) correct all misstatements noted. For example, as a control, an accounting system may identify and put exception transactions into a suspense file or account. Lack of timely follow-up procedures 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.

.08 When evaluating whether controls are likely to be effective, the auditor should consider whether the controls also are applied effectively to adjustments/corrections made to the financial records. Such adjustments/corrections may occur at the transaction level, during summarization of the transactions, or may be posted directly to the general ledger accounts.

.09 Based on the understanding of control activities and the determination as to whether they are likely to achieve the control objectives, the auditor reassesses control risk to decide whether to test controls. If control risk is high because the control activities for a particular accounting application are not effective in design or not effective in operation (based on prior years' testing of the control activities and management's indication that they have not improved), the auditor does not need to test the controls. If they are effective, the auditor must test them, but may consider using a rotation approach to testing the controls, as discussed in section 395 G.

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350 - DETERMINE THE NATURE, TIMING, AND EXTENT OF CONTROL TESTS AND OF TESTS FOR SYSTEMS' COMPLIANCE WITH FFMIA REQUIREMENTS

.01 For each control objective, the auditor should (1) identify specific relevant control activities to test, (2) perform walkthroughs to be sure that those controls are in operation, (3) document these control activities on the SCE worksheet or equivalent, (4) determine the nature and timing of control tests, and (5) determine the extent of control tests. Internal control includes IS controls, as discussed further in paragraphs 360.03-.10 and the FISCAM. For the controls over performance measures reported in the MD&A (overview) of the Accountability Report, the auditor does not need to test controls (although he or she may decide to do so), but should identify the activities likely to achieve the objectives, perform walkthroughs to be satisfied that the controls have been placed in operation, and document the controls.

.02 The auditor also should determine the nature, timing, and extent of tests for compliance of the entity's systems with federal financial management systems requirements (these requirements are established by OMB Circular A-127 and include the Joint Financial Management Improvement Program's series of system requirements documents), federal accounting standards (GAAP - see section 560), and the SGL at the transaction level in order to report in accordance with FFMIA. 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, have effective internal control, and comply with legal and regulatory requirements.

.03 If it is likely that the financial statement opinion will be unqualified and internal control will be determined to be effective, the auditor should plan to test the systems' compliance with the requirements. Many nonsampling control tests will also test for compliance with the systems requirements and the SGL, although determining compliance with federal accounting standards (GAAP) will also require substantive testing. In designing control and substantive tests, the auditor should keep in mind the need to report whether the entity's financial management systems are in substantial compliance with FFMIA requirements so that the control and other tests may serve this dual purpose. In addition, for purposes of FFMIA financial management systems include systems that produce the information management uses day-to-day, not just systems that produce annual financial statements. Thus, the auditor should test the financial management systems used for managing financial operations and supporting financial planning, management reporting, budgeting activities, and systems accumulating and reporting cost information, including the financial portion of mixed systems.

.04 For agencies with longstanding, well-documented financial management systems weaknesses that severely affect the systems' ability to comply with FFMIA requirements, the auditor need not perform specific tests of the systems' compliance with the FFMIA requirements. The auditor will generally have adequate information about the systems to describe the instances of lack of substantial compliance and make recommendations, as required by FFMIA, by gaining an understanding of the systems and performing internal control and substantive testing. The auditor also should understand management's process for determining whether its systems comply with the FFMIA requirements and report any deficiencies in management's process (for example, management has not compared its systems with JFMIP systems requirements). The auditor's report should make clear that there may be other areas of noncompliance.

.05 Similarly, if it is likely that the opinion on the financial statements will not be unqualified, that the entity has material weaknesses or reportable conditions in internal control, or that it has significant noncompliance with legal and regulatory requirements, then the auditor may limit the scope of testing performed to support an FFMIA assessment. However, if the auditor is concerned that he or she may find it difficult to convince management of the systems' noncompliance without specific tests, the auditor ahould perform them. Also, the auditor should recognize that if controls have improved and/or an unqualified opinion can be expressed, the auditor will need to test systems for FFMIA compliance.

IDENTIFY RELEVANT CONTROL ACTIVITIES TO TEST

.06 For each control objective identified in Section 330, the auditor should identify the control activity, or combination of control activities, that is likely to (1) achieve the control objective and (2) maximize the overall efficiency of control tests. In doing this, the auditor should consider (1) the extent of any inherent risk[1] and control environment, risk assessment, communication, or monitoring weaknesses,[2] including those related to IS (as documented in the ARA and/or GRA document or equivalent (see section 260)) and (2) the tentative determination of the likelihood that IS controls will be effective, as determined in the planning phase (see section 270). The auditor should test only the control activities necessary to achieve the objective. For example, the entity may have several controls that are equally effective in achieving an objective. In such a case, the auditor should select and test the control activity that is most efficient to test, considering such factors as (1) the extent to which a control achieves several control objectives and thereby reduces the number of controls that would ordinarily need to be tested and (2) the time that will be required to test the control.

.07 For those control objectives for which the auditor preliminarily determines that effective control activities exist or are likely to exist, the auditor should test the selected control activities, as discussed in sections 360 and 450. The auditor may test all, or only certain control activities (because others are not likely to be effective), related to a control objective. However, the auditor may <u>not</u> elect to forgo control tests solely because it is more efficient to extend substantive or compliance audit procedures. If, in any phase of the audit, the auditor determines that control activities selected for testing are, in fact, ineffective in design or operation, the auditor should discontinue the specific control evaluation of related control objectives and should report resulting weaknesses in internal control as discussed in section 580. If the entity's management does not agree with the auditor's conclusion that

1 Assertions that have high inherent risk normally require stronger or more extensive controls to prevent or detect misstatements than assertions without such risk.

2 Control environment, risk assessment, communication, and monitoring weaknesses may result in ineffective control activities. If so, the auditor should still identify and test specific control activities, but the extent of such testing should be limited, as discussed in paragraph 340.02.

effective control activities do not exist or are unlikely to exist, the auditor may need to perform procedures sufficient to support that conclusion.

.08 Before testing controls the auditor believes will be effective, the auditor may elect to complete the ARA or equivalent tentatively, assuming that such controls are effective.

PERFORM WALKTHROUGHS TO DETERMINE WHETHER THOSE CONTROLS ARE IN OPERATION

.09 Before performing control tests, the auditor should perform one or more walkthroughs to determine whether the control activities are functioning in the manner understood by the auditor. These walkthroughs, designed to confirm the auditor's understanding of the control activities, differ from those performed to confirm the auditor's understanding of the systems in which they operate (see paragraph 320.02). Through observations, inspection, and discussions with personnel responsible for applying or maintaining each control (including walkthroughs), the auditor should determine whether each control has, in fact, been placed in operation. If a control has not been placed in operation, the auditor should consider whether other controls are likely to achieve the related control objective(s) and should consider testing such controls.

DOCUMENT CONTROL ACTIVITIES TO BE TESTED

.10 The auditor should document the control activities to be tested on the SCE worksheet or equivalent. (See an illustration in section 395 H.) (Other components of internal control are generally tested by observation and inquiry in the planning phase. See paragraph 260.09.) Controls that satisfy more than one control objective may be listed (and evaluated) only once and referred to, when applicable, on subsequent occasions. For each control to be tested, the auditor should determine whether the control is an IS control. An IS auditor generally should review and concur with the auditor's identification of IS controls.

DETERMINE THE NATURE AND TIMING OF CONTROL TESTS

.11 To obtain additional evidence of the effectiveness of specific controls, the auditor should select the combination of control tests (observation, inquiry, or inspection) to be performed and determine the timing of such tests. No one specific control test is always necessary, applicable, or equally effective in every circumstance. In fact, a combination of these types of control tests is usually needed to provide the necessary level of assurance. In determining the types of tests to apply, the auditor should select the tests that are effective and most efficient, as discussed in paragraphs 350.15-.18. Specific types of control tests and methods to apply them are discussed below.

.12 **Observation -** The auditor conducts observation tests by observing entity personnel actually performing control activities in the normal course of their duties. 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, observation tests should be supplemented by corroborative evidence obtained from other tests (such as inquiry and inspection) about the operation of controls at other times.

.13 **Inquiry -** The auditor conducts inquiry tests by making 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. Generally, evidence obtained through inquiry is the least reliable audit evidence and generally should be corroborated through other types of control tests (observation or inspection). The reliability of evidence obtained from inquiry depends on various factors, such as 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 was 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.

- Whether the evidence was provided orally or in writing. Generally, evidence provided in writing is more reliable than evidence provided orally.

.14 **Inspection -** The auditor conducts inspection tests by examining documents and records for evidence (such as the existence of initials or signatures) that a control activity was applied to those documents and records. System documentation, such as operations manuals, flow charts, and job descriptions, may provide evidence of control design but do not provide evidence that controls are actually operating and being applied consistently. 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 is frequently used in multipurpose testing. Because evidence of performance is documented, this type of test can be performed at any time. The evidence previously obtained from (1) the inspection of documents in walkthroughs (in which inspection is performed to a lesser extent than in sampling control tests) and (2) observation or inquiry tests may provide sufficient evidence of control effectiveness. However, if the auditor needs additional evidence, sampling items for inspection should be considered. Since documentary evidence generally does not provide evidence concerning how effectively the control was applied, the auditor generally should supplement inspection tests with observation and/or inquiry of persons applying the control. For example, the auditor generally should supplement inspection of initials on documents with observation and/or inquiry 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.

.15 The type of control test or tests the auditor selects depends on (1) the nature of the control to be tested and (2) the timing of and period covered by the control test.

.16 The **nature of the control** influences the type of evidential matter that is available. For example, if the control provides documentary evidence, the auditor may decide to inspect the documentation. For other controls, such documentation may not be available or relevant. For example, segregation-of-duties controls generally do not provide documentary evidence. In such circumstances, the auditor may obtain evidential matter about the effectiveness of the control's operation through observation or inquiry.

.17 The **timing of and period covered by the control test** require consideration. The evidential matter should relate to the audit period and, unless it is documentary evidence, should be obtained 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 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. Paragraph 380.02 provides guidance concerning situations when new controls are implemented during the year.

.18 When selecting a particular control test from among equally effective tests, the auditor should select the most efficient test. For example, the auditor may find that inquiry, observation, and walkthroughs (tests of controls that do not involve sampling) provide sufficient evidence that the control was effective during the year and are most efficient to test. When sampling is considered necessary, the auditor should consider performing multipurpose tests to enhance audit efficiency (see sections 430 and 450).

DETERMINE THE EXTENT OF NONSAMPLING CONTROL TESTS

.19 After selecting 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, the nature of the control to be tested, the nature and availability of evidential matter, and the auditor's determination of the amount of additional evidence needed. For each control activity considered necessary to achieve the control objectives, the auditor should test the control activity to determine whether it achieves the control objectives. Relevant financial reporting, budget, compliance, and operations controls generally should be tested to the same level of assurance. The extent of this testing is discussed in section 360 for nonsampling control tests and in section 450 for sampling control tests.

.20 Controls that do not leave documentary evidence of existence or application generally cannot be tested with sampling procedures. When control activities, such as segregation of duties, do not leave documentary evidence, the auditor should test their effectiveness by observation and/or inquiry. For example, the auditor may obtain evidential matter about the proper segregation of duties by (1) direct observation of the control activities being applied at a specific time during the audit period and (2) inquiry of the individual(s) involved about applying the activities at other times during the audit period. The appropriate extent of observation and inquiry is not readily quantifiable. To determine whether a control is effective, the auditor should consider whether sufficient evidence has been obtained to support the preliminary assessment of control effectiveness (see section 370).

DETERMINE THE NATURE, TIMING, AND EXTENT OF TESTS FOR SYSTEMS' COMPLIANCE WITH FFMIA REQUIREMENTS

.21 If the auditor believes it is likely that the opinion on the financial statements will be unqualified (or qualifications will not relate to the entity's ability to prepare reliable financial statements or provide reliable financial information when needed), that internal control will be determined to be effective, and that the auditor will find no instances of noncompliance with legal and regulatory requirements, then the auditor should test each of the elements of systems' compliance with FFMIA requirements. Also, the auditor may need to test for systems' compliance with FFMIA requirements in other circumstances, as discussed in paragraph 350.05.

.22 The determination of substantial compliance with the requirements requires auditor judgment. To assist the auditor in making these judgments, he or she should identify any management-developed documentation for its assertion about the systems' conformance with systems requirements in its FMFIA section 4 report and any work it may have done for FFMIA. The documentation may include the Financial Management Series of Checklists for Systems Reviewed Under the Federal Financial Management Improvement Act of 1996 or other tools. The issues discussed earlier in this section with regard to nature, timing, and extent of control tests also apply to tests of systems' compliance with FFMIA requirements. These tests generally should be done concurrently with nonsampling control tests as described in section 360.

.23 Management's documentation may be the basis for tests of the systems' compliance. If, for example, management provides the auditor with a checklist detailing the functions the systems are able to perform, the auditor generally should select some significant functions from the checklist and determine whether the systems perform them. This may be done based on knowledge the auditor has acquired from gaining an understanding of the systems, as well as by additional observation, inquiry, inspection, and walkthroughs as discussed earlier in this section for control tests. If management has not provided documentation, testing may be based directly on the FFMIA requirements. If management is unable to provide any documentation, the auditor should ask why there is no documentation and how management knows whether it is in compliance. Lack of documentation often indicates that the systems do not substantially comply with FFMIA.

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360 - PERFORM NONSAMPLING CONTROL TESTS AND TESTS FOR SYSTEMS' COMPLIANCE WITH FFMIA REQUIREMENTS

.01 The auditor should design and conduct tests of control activities that are effective in design to confirm their effectiveness in operation. (The auditor should refer to paragraph 380.02 if control activities were not effective in design during the entire audit period.) The auditor should perform the following procedures in connection with control tests:

- Request an IS auditor to test IS controls.
- Perform nonsampling control tests. (Sampling control tests are performed in the testing phase, as discussed in section 450.)
- Evaluate the results of nonsampling control tests.

.02 Similarly, the auditor should design and conduct tests of the financial management systems' compliance with the three FFMIA requirements, if he or she determined such tests were necessary (see paragraphs 350.02-.05 and 350.21-.23). Many nonsampling control tests will also serve as tests for compliance with FFMIA requirements, especially the systems requirements and the SGL, although testing for federal accounting standards (GAAP) will include substantive testing, done as part of the testing phase.

TESTS OF IS CONTROLS

.03 In an entity that uses information systems to perform accounting functions, the auditor might identify controls whose effectiveness depends on the computer (IS controls). Such IS controls are discussed in more detail in section 295 F. Due to the technical nature of certain IS controls, an IS auditor should perform or supervise tests of such controls and should document conclusions on the effectiveness of IS controls during the audit period. The financial auditor may perform tests of less technical IS controls but the IS auditor should supervise such testing to evaluate the results and to consider such controls in relation to other IS controls.

.04 If IS controls are identified for testing, an IS auditor should evaluate the effectiveness of

- general controls at the entity or installation level;
- general controls as they relate to the application to be tested; and
- specific application controls and/or user controls, unless the IS controls that achieve the control objectives are general controls.

.05 The IS auditor should determine whether overall or installation-level general controls are effectively designed and operating by

- identifying applicable general controls,
- determining how those controls function, and
- evaluating and testing the effectiveness of those controls.

The IS auditor should consider knowledge obtained in the planning phase. At the conclusion of this step, the IS auditor should document the understanding of general controls and should conclude whether such controls are effectively designed and operating as intended.

Tests of General Controls at the Installation Level

.06 General controls ordinarily are tested through a combination of procedures, including observation, inquiry, inspection (which includes a review of documentation on systems and procedures), and reperformance using appropriate test software. Although sampling is generally not used to test general controls, it may be used to test certain controls, such as those involving approvals.

.07 If general controls are not effectively designed and operating as intended, the auditor will generally be unable to obtain satisfaction that application controls are effective. In such instances, (1) the IS auditor should discuss the nature and extent of risks resulting from ineffective general controls with the audit team and (2) the auditor should consider whether manual controls achieve the control objectives that the IS controls were supposed to achieve.

However, if manual controls do not achieve the control objectives, the IS 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 due to poor general controls, testing would typically not be necessary, except to support findings.

Tests of General Controls at the Application Level

.08 Based on favorable conclusions reached on general controls at the entity or installation level, the IS auditor should evaluate and test the effectiveness of general controls for those applications within which application controls or user controls are to be tested.

.09 If general controls are not operating effectively within the application, application controls and user controls generally will be ineffective. In such instances, the IS auditor should discuss the nature and extent of risks resulting from ineffective general controls with the audit team and should determine whether to proceed with the evaluation of application controls and user controls.

Tests of Application Controls and User Controls

.10 The IS auditor generally should perform or supervise tests of those application controls and user controls necessary to achieve the control objectives where the overall and application-level general controls were determined to be effective.

NONSAMPLING CONTROL TESTS

.11 The auditor should (1) develop a detailed control test audit program that incorporates the nature, timing, and extent of planned nonsampling control tests, including tests for compliance with FFMIA requirements and (2) perform nonsampling control tests according to the audit program. The following paragraphs discuss the testing of segregation of duties.

Segregation of Duties

.12 Nonsampling control tests relating to segregation of duties require special consideration. Such 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. Paragraph 330.08 describes situations in which the auditor should test segregation of duties.

.13 The auditor may use the following method to test segregation-of-duties controls:

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. Direct access exists when the individual is authorized to handle the assets directly (such as during the processing of cash receipts). Indirect access exists when the individual 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 IS provides access to assets, evaluation and testing of IS controls should be designed to identify (1) individuals (including IS personnel) who may use the computer to obtain access and (2) asset access controls over such individuals.

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 made by that person. In an IS accounting system, 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 consider whether other controls would mitigate the effects of this lack of asset access control.

EVALUATING THE RESULTS OF NONSAMPLING TESTS

.14 The auditor should investigate and understand the reasons for any deviations from control activities noted during nonsampling control tests. 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 should conclude 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 one month due to personnel turnover. For all but that month, the auditor may assess controls as effective and reduce related testing. The auditor also should consider whether other controls can achieve the related control objective(s).

.15 Additionally, the auditor should gather sufficient evidence to report the control weakness. As discussed in paragraphs 580.37-.58, the significance of the weakness will determine how the auditor reports the finding and therefore which elements of the finding (condition, cause, criteria, effect, and recommendation or suggestion) need to be developed.

.16 Finally, the auditor may make preliminary conclusions as to whether the entity's financial management systems substantially comply with federal financial management systems requirements, federal accounting standards (GAAP), and the SGL at the transaction level. However, a final conclusion as to compliance, especially with federal accounting standards, needs to wait for the results of substantive testing.

370 - ASSESS CONTROLS ON A PRELIMINARY BASIS

.01 Based on the evaluation of internal control and results of nonsampling control tests, the auditor should preliminarily assess the effectiveness of internal control during the period (for reporting on internal control in a non-opinion report and for determining the extent of procedures to be performed in the testing phase) and/or as of the end of the period (for an opinion on internal control). Considerations for assessing the effectiveness of IS controls and each type of control (financial reporting (including safeguarding and budget), compliance, and operations) are discussed in paragraphs 370.06-.14 below and in the FISCAM.

.02 To assess the effectiveness of internal control, the auditor considers whether the control objectives are achieved. For each control objective that is not fully achieved, the auditor should obtain sufficient (1) information to develop comments in the auditor's report or management letter (see paragraphs 580.32-.61) and (2) evidence to support the preliminary assessment of the effectiveness of internal control.

INFORMATION SYSTEM RESULTS

.03 Based on the procedures performed, the IS auditor should discuss conclusions on the effectiveness of IS controls with the audit team and obtain concurrence. The auditor should (1) incorporate the IS auditor's conclusions into the audit workpapers for each IS control tested and (2) perform tests of application controls (principally manual follow-up of exceptions) or user controls identified by the IS auditor for the audit team to test.

.04 If IS controls are determined to be effective, the auditor may also ask the IS auditor to identify any IS controls within the applications tested using the above procedures that were not previously identified by the auditor. 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 auditor can assist the auditor in determining the cost effectiveness of searching for and testing additional IS controls. Decisions made in response to these considerations should be documented, including a description of the expected scope of the IS auditor's work.

.05 Audit programs and supporting workpapers should be prepared to document the procedures for evaluating and testing the effectiveness of IS controls. Such workpapers should be included in the audit workpapers.

FINANCIAL REPORTING CONTROLS

.06 Based on procedures performed and before sampling control tests,[1] if any, the auditor should form a preliminary conclusion about (1) the effectiveness of financial reporting controls as of the end of the period and (2) the assessed level of control and combined risk during the period for each significant assertion in each significant line item or account. Combined risk is the risk that, prior to the application of substantive audit procedures, a material misstatement exists in a financial statement assertion. Combined risk consists of the risks that (1) a financial statement assertion is susceptible to material misstatement (inherent risk) and (2) such misstatement is not prevented or detected on a timely basis by the entity's internal control (control risk). The use of professional judgment is essential in assessing both control and combined risk.

.07 **Preliminary assessment of control risk.** For each significant assertion in each significant account, the auditor should assess control risk at one of the following three levels:

- **Low control risk:** The auditor believes that controls will prevent or detect any aggregate misstatements that could occur in the assertion in excess of design materiality.
- **Moderate control risk:** The auditor believes that controls will more likely than not prevent or detect any aggregate misstatements that could occur in the assertion in excess of design materiality.
- **High control risk:** The auditor believes that controls will more unlikely than likely prevent or detect any aggregate misstatements that could occur in the assertion in excess of design materiality.

[1] The auditor may assess control and combined risk on a preliminary basis at an earlier point in the audit, if preferred.

.08 In assessing control risk in a line item/account assertion, the auditor should consider the aggregate magnitude of misstatements that might not be prevented or detected in significant accounting applications that affect the line item or account. For example, the cash receipts, cash disbursements, and payroll accounting applications typically affect the cash account. Accordingly, the auditor should consider the risk that aggregate misstatements could arise from a combination of those accounting applications and not be prevented or detected by controls.

.09 **Preliminary assessment of combined risk.** In assessing combined risk, the auditor should consider the likelihood that a material misstatement would occur (inherent risk) and not be prevented or detected on a timely basis by the entity's internal control (control risk). This preliminary assessment of combined risk should be consistent with the auditor's assessment of inherent risk and control risk. For each significant assertion in each significant account, the auditor should assess combined risk at one of the following three levels:

- **Low combined risk:** Based on the evaluation of inherent risk and control risk, but prior to the application of substantive audit procedures, the auditor believes that any aggregate misstatements in the assertion do not exceed design materiality.

- **Moderate combined risk:** 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 likely than not that any aggregate misstatements in the assertion do not exceed design materiality.

- **High combined risk:** 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 unlikely than likely that any aggregate misstatements in the assertion do not exceed design materiality. As a result, the auditor will need to obtain most, if not all, audit reliance from substantive tests.

.10 The minimum substantive assurance level required for substantive tests varies directly with combined risk. In other words, as combined risk increases, so does the minimum substantive assurance level. Section 470 discusses the assurance level. The auditor should document the preliminary assessment of control risk and combined risk in the ARA or equivalent.

COMPLIANCE CONTROLS

.11 Based on the results of compliance control tests and other audit procedures, the auditor should

- conclude whether the entity's internal control provides reasonable assurance that the entity complied with the significant provisions of laws and regulations and executed transactions in accordance with budget authority during the period (to assess control risk, to test compliance as discussed in section 460, and/or to report (non-opinion report) on internal control) and/or as of the end of the period (to support the opinion on internal control) and

- report weaknesses in compliance controls that come to the auditor's attention (see paragraphs 580.32-.61).

If compliance controls are effective in preventing or detecting noncompliance with relevant provisions of laws and regulations during the period, the extent of compliance testing can be less than if such controls were not effective, as discussed in section 460.

.12 When forming conclusions on internal control related to budget execution, the auditor should consider the impact of any unadjusted 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 consider whether these misstatements are indications of weaknesses 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 OGC.

OPERATIONS CONTROLS

.13 If the results of control tests indicate that operations controls were not effective during the period, the auditor should not place reliance on the ineffective operations controls when performing other audit procedures. Based on gaining an understanding of performance measures systems and other procedures (which may include optional tests of controls), the auditor will have an understanding of the design of performance measures controls as they relate to the existence and completeness assertions (for GAO audits, the valuation assertion is also included in the understanding) and whether they have been placed in operation. The auditor should report weaknesses in performance measures controls that come to his or her attention. See paragraphs 580.32-.61 regarding reporting of control weaknesses.

REEVALUATION OF CONTROL RISK AND COMBINED RISK ASSESSMENT

.14 After completing the testing phase, discussed in section 400, the auditor should reevaluate the preliminary assessment of control risk for financial reporting controls and control effectiveness for compliance and operations controls. If the test results are contrary to the preliminary assessment, the auditor should reconsider the adequacy of the audit procedures performed and perform additional procedures as considered necessary.

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380 - OTHER CONSIDERATIONS

ROTATION TESTING OF CONTROLS

.01 When the entity's control environment, risk assessment, communication, and monitoring are strong and inherent and fraud risk are low, using a rotation approach for testing controls may be appropriate for IS controls. When appropriate, based primarily on favorable results from prior tests and limited work in the current year, the auditor may test IS internal controls of certain cycles/applications on a rotating basis rather than every year. Rotation is generally not appropriate for use in first-time audits where an opinion is expressed or for audits of entities that do not have strong control environments, risk assessment, communication, and monitoring. Section 395 G provides additional requirements and guidelines for rotation testing of controls.

PARTIAL-YEAR CONTROLS

.02 In certain situations, such as when new controls are implemented during the year, the auditor may elect to test controls only for the period that the new controls were operating. In such situations, the extent of control testing should remain similar, but be concentrated over the period the new controls are in place. For any portion of the audit period that financial reporting, budget, and compliance controls were not tested directly or through a rotation plan (see paragraph 380.01), the auditor should assume that such controls were ineffective for purposes of designing compliance and substantive tests.

PLANNED CHANGES IN CONTROLS

.03 The auditor may become aware of an entity's plans to implement new accounting or control systems after the audit period ends. Even though new systems or controls are planned, the auditor should evaluate and test controls in effect through the end of the audit period to (1) provide support for the report on internal controls, (2) recommend any improvements to the current system that should be considered in designing the new systems or controls, and/or (3) obtain audit evidence to reduce substantive testing in the current audit. During the current audit, the auditor may elect to review controls designed into the new system.

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390 - DOCUMENTATION

.01 In addition to preparing a control testing audit program and other workpapers relevant to the internal control phase, the auditor should prepare the documents described in paragraphs 390.04-.07 or their equivalent.

.02 In the audit program, the auditor generally should explain the objectives of audit procedures. Also, written guidance, either within or accompanying the audit program to explain possible exceptions, their nature, and why they might be important, may help auditors focus on key matters, more readily determine which exceptions are important, and identify significant exceptions.

.03 As the audit work is performed, the auditors may become aware of possible reportable conditions or other matters that should be communicated to the auditee. The auditor generally should document and communicate these as described in paragraph 290.02.

CYCLE MEMORANDUM AND FLOWCHART

.04 The auditor is required to document (AU 319.44) the understanding gained of each component of internal control, among them, the information system (AU 319.36). The auditor should prepare sufficient documentation to clearly describe and illustrate the accounting system; such documentation may include memorandums and flowcharts. Flowcharts provide a good mechanism to document the process and need not be extremely detailed. In some systems, particularly IS, it is difficult to understand the system without a flowchart. For each significant cycle, the auditor should prepare a cycle memorandum or equivalent, and a complementary flowchart of the cycle and component accounting application(s) is also recommended. To the extent relevant, these documents should include the following accounting systems information for financial reporting controls:

- The **cycle memorandum** or equivalent should (1) identify the cycle transactions, each significant accounting application, and each significant financial management system included in the cycle, (2) describe interfaces with other cycles, (3) identify financial statement line items and general ledger accounts included in the cycle, (4) describe the operating policies and procedures relating to the processing of cycle transactions (see paragraph 320.03),[1] and (5) identify major internal controls (overview only). The cycle memorandum may also include information on FFMIA requirements considered to this point, such as systems requirements and the SGL.

- The **flowchart** should complement the related cycle memorandum and summarize the significant transaction flows in terms of (1) input and report documents, (2) processing steps, (3) files used, (4) units involved, and (5) interfaces with other cycles and accounting applications.[2]

.05 The auditor should document the understanding of compliance and relevant operations (including performance measures) control systems in a memorandum and, if applicable, a flowchart addressing each point discussed in paragraphs 320.05-.07.

SPECIFIC CONTROL EVALUATION WORKSHEET

.06 The auditor should document the evaluation of specific control activities in the SCE worksheet or equivalent. Control tests should be documented in a control test audit program and in accompanying workpapers. Any IS control tests should also be documented in the audit workpapers, as discussed in paragraph 370.05. Section 395 H presents an example of a completed SCE worksheet.

UPDATING THE ACCOUNT RISK ANALYSIS FORM

.07 The auditor should update the ARA form or equivalent by completing the internal control phase columns, as illustrated in section 395 I.

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1 Specific relevant control activities will be documented later in the specific control evaluation worksheet or equivalent, after related control objectives have been identified. (See paragraphs 330.02-.11.)

2 Although the auditor may gather information on control activities in preparing the flowchart, such techniques should be documented in the SCE worksheet or equivalent, if applicable, and need not be documented in the flowchart.

395 A - TYPICAL RELATIONSHIPS OF ACCOUNTING APPLICATIONS TO LINE ITEMS/ACCOUNTS

This section illustrates the typical relationships between accounting applications and line items or accounts. For example, sources of significant accounting entries to cash typically include the cash receipts, cash disbursements, payroll, and cash accounting applications. For each significant line item or account, the auditor should develop an understanding of how potential misstatements in significant accounting applications could affect the related line item or account. In turn, control objectives and relevant control techniques to achieve those objectives should be identified.

Line items/ accounts	Transaction-related accounting applications					Line item/account-related accounting applications					
	Billing	Cash receipts	Pur-chasing	Cash disburse-ments	Payroll	Cash	Accounts receivable	Inven-tory	Property	Accounts payable	Obliga-tion
Cash or FBWT		X		X	X	X					
Accounts receivable	X	X					X				
Inventory	X		X					X			
Property			X						X		
Liabilities			X	X						X	
Revenue	X										
Expenses			X		X						
Obligations			X	X							X

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395 B - FINANCIAL STATEMENT ASSERTIONS AND POTENTIAL MISSTATEMENTS

This section lists potential misstatements that could occur in each financial statement assertion within an accounting application, together with related control objectives. The auditor should use judgment to tailor this information to the accounting application and to the entity and should consider supplementing this list with other control objectives or subobjectives. The assertions, potential misstatements, and control objectives illustrated in this section can be used in preparing the first, fourth, and fifth columns of the SCE worksheet, which is illustrated in section 395 H. However, this section is provided as a reference and does not require completion as a form.

Assertion	Potential misstatement	Control objective
	Transaction-related	
Existence or occurrence	Validity: 1. Recorded transactions do not represent economic events that actually occurred.	1a. Recorded transactions, underlying events, and related processing procedures should be authorized by federal laws, regulations, and management policy. 1b. Recorded transactions should be approved by appropriate individuals in accordance with management's general or specific criteria. 1c. Recorded transactions should represent events that actually occurred and should be properly classified.
	Cutoff: 2. Transactions are recorded in the current period, but the related economic events occurred in a different period.	2. Transactions recorded in the current period should represent economic events that occurred during the current period.
	Summarization: 3. Transactions are summarized improperly, resulting in an overstated total.	3. The summarization of recorded transactions should not be overstated.

Assertion	Potential misstatement	Control objective
	Line item/account-related	
	Substantiation: 4. Recorded assets and liabilities do not exist at a given date.	4a. Recorded assets and liabilities should exist at a given date. 4b. Recorded assets and liabilities of the entity, at a given date, should be supported by appropriate detailed records that are accurately summarized and reconciled to the account balance. 4c. Access to assets, critical forms, records, and processing and storage areas should be permitted only in accordance with laws, regulations, and management policy.
Completeness	Transaction-related	
	Transaction completeness: 5. Valid transactions are not recorded.	5. All valid transactions should be recorded and properly classified.
	Cutoff: 6. Economic events occur in the current period, but the related transactions are recorded in a different period.	6. All economic events that occurred in the current period should be recorded in the current period.
	Summarization: 7. Transactions are summarized improperly, resulting in an understated total.	7. The summarization of recorded transactions should not be understated.
	Line item/account-related	
	Account completeness: 8. Assets and liabilities of the entity exist but are omitted from the financial statements.	8. All accounts that belong in the financial statements should be so included. There should be no undisclosed assets or liabilities.

Assertion	Potential misstatement	Control objective
	Transaction-related	
Valuation or allocation	Accuracy: 9. Transactions are recorded at incorrect amounts.	9. Transactions should be recorded at correct amounts.
	Line item/account-related	
	Valuation: 10. Assets and liabilities included in the financial statements are valued on an inappropriate basis.	10. Assets and liabilities included in the financial statements should be valued on an appropriate valuation basis.
	Measurement: 11. Revenues and expenses included in the financial statements are measured improperly.	11. Revenues and expenses included in the financial statements should be properly measured.
	Line item/account-related	
Rights and obligations	Ownership: 12. Recorded assets are owned by others because of sale, consignment, or other contractual arrangements.	12. Recorded assets should be owned by the entity.
	Rights: 13. The entity does not have certain rights to recorded assets because of liens, pledges, or other restrictions.	13. Assets should be the entity's rights at a given date.
	Obligations: 14. The entity does not have an obligation for recorded liabilities at a given date.	14. Liabilities should be the entity's obligations at a given date.
	Line item/account-related	
Presentation and disclosure	Account classification: 15. Accounts are not properly classified and described in the financial statements.	15. Accounts should be properly classified and described in the financial statements.

Assertion	Potential misstatement	Control objective
	Consistency: 16. The financial statement components are based on accounting principles different from those used in prior periods. Disclosure: 17. Required information is not disclosed in the financial statements or in the footnotes thereto.	16. The financial statement components should be based on accounting principles that are applied consistently from period to period. 17. The financial statements or footnotes thereto should contain all information required to be disclosed.
	Transaction-related	
(See note below)	Segregation of duties: 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 should be prevented from having uncontrolled access to both assets and records.

Note: Segregation-of-duties controls are a type of safeguarding control and are often crucial to the effectiveness of controls, particularly over liquid, readily marketable assets that are highly susceptible to theft, loss, or misappropriation. Such controls are designed to reduce the opportunities for any person to be in a position to both perpetrate and conceal fraud. The lack of segregation-of-duties controls may be pervasive and affect several misstatements. Paragraph 330.08 discusses when segregation-of-duties controls should be tested.

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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, and management policy. Typical authorization controls include

- documented policies establish events or transactions that the entity is authorized to engage in by law, regulation, or management policy;
- documented policies and procedures exist for processing transactions in accordance with laws, regulations, or management policy; and
- master files include only authorized employees, customers, or suppliers.

APPROVAL

.02 Approval controls are designed to provide reasonable assurance that appropriate individuals approve recorded transactions in accordance with management's general or specific criteria. Typical approval controls include the following:

- Specific transactions 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.

- Key records are matched before a transaction 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 on-line approval of input before processing.

SEGREGATION OF DUTIES

.03 Segregation-of-duties controls are designed to reduce the opportunities for someone to both perpetrate and conceal errors or 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 records. See paragraphs 330.08 and 360.11 for additional discussions of segregation-of-duties controls.

DESIGN AND USE OF DOCUMENTS AND RECORDS

.04 The purpose of controls over the design and use of records is to help provide reasonable assurance that transactions and events are properly 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, etc., 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 promptly.

- 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 recording transactions more than once. Also, only original documents are used to process transactions.

ADEQUATE 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 <u>unauthorized</u> access to assets and records. Evaluation of segregation of duties is also required for persons who have <u>authorized</u> access to assets and records. Typical access controls follow:

- Cash receipt totals are recorded before cash is transmitted for deposit.

- 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 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.)

- 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 given up only on the basis of proper authorization (such as a purchase order, contract, or shipping order) in accordance with established procedures.

- Procedures are established to 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 in this category are designed to provide independent checks on the validity, accuracy, and completeness of processed data. The following procedures are typical of this category of controls:

- Calculations, extensions, additions, and accounting classifications are independently reviewed. (For example, arithmetic on vouchers is independently recomputed, 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 OF RECORDED AMOUNTS

.07 Controls in this category are designed to provide assurance that assets are valued at appropriate amounts. Typical valuation controls follow:

- Periodically, the condition and marketability of assets are evaluated. (For example, inventory is periodically reviewed for physical damage, deterioration, or obsolescence, or receivables are evaluated for collectibility).

- 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.

SUMMARIZATION OF ACCOUNTING DATA

.08 Controls in this category are designed to provide 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 subsidiary ledgers, journals, and/or other records) are compared with the underlying subsidiary records and/or documents before the data are accepted for inclusion in summarized records and reports. (For example, journal entries are compared to source documents, and the daily summaries of journal entries are compared with 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 application to another are compared).

RIGHTS AND OBLIGATIONS

.09 Controls in this category are designed to provide assurance that (1) the entity owns recorded assets, with the ownership supported by appropriate documentation, (2) the entity has the rights to its assets at a given date, and (3) recorded liabilities reflect the entity's legal obligations at a given date. The following procedures are typical of this category of controls:

- 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

.10 Controls in this category are designed to provide assurance that (1) accounts are properly classified and described in the financial statements, (2) the financial statements are prepared in conformance with GAAP, and (3) footnotes contain all information required to be disclosed. The following procedures are typical of this category of controls:

- Policies and procedures are documented for accumulating and disclosing financial information in the financial statements by appropriate personnel. Responsibility is assigned to specific individuals.

- Policies and procedures are documented for preparing financial statements by authorized personnel having sufficient experience and expertise to assure compliance with GAAP.

- Policies and procedures are documented (such as policy and procedures manuals, together with organization charts) for properly classifying and describing financial information in the financial statements.

- Reports are periodically substantiated and evaluated by supervisory personnel. Procedures are implemented to detect errors and omissions and to evaluate recorded balances.

- A written chart of accounts containing a description of each account is used, such as the SGL. Journal entries are prepared, reviewed, compared with supporting details where necessary, and approved each accounting period.

- Appropriate processing procedures are used, including control or batch totals, etc. 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.

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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 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. sections 1341-1342, 1349-1351, and 1511-1517 for further information.)

.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.) Annual or multiple year appropriations often are referred to as "fixed accounts." Fixed accounts are available for obligation for a definite period of time. "No year" authority or accounts are resources that are available for obligation for an indefinite period of time, usually until the purposes for which they were provided are carried out.

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395 E - BUDGET EXECUTION PROCESS

.01 The steps of a simplified budget process are illustrated in the following table.

General phases	Events	Accounting recognition
Preparation	Budget submission	None
Approval	Granting budget athority	Appropriations
Execution	Delegation of authority	Apportionment
		Allotment
	Use of authority	Commitment
		Obligation
		Expended
		Outlay

.02 The following budget execution process is of interest to the auditor when testing the statement of budgetary resources and when evaluating an entity's internal control relating to budget execution:[1]

- Congress provides an entity with an **appropriation (or other budget authority)**, which is authority provided by law to enter into obligations that result in immediate or future outlays (2 U.S. 622(2)).

  The Secretary of the Treasury issues **warrants**, which establish the amount of moneys authorized to be withdrawn from the central accounts maintained by Treasury.

- 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, or

1 For additional information on budget execution, see OMB Circular A-34, *Instructions on Budget Execution*, November 3, 2000.

objects, or a combination thereof. The amounts so apportioned limit the amount of obligations that may be incurred.

- 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).

- 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 considered formal/official use of budget authority. Rather, commitments are used by entities for financial planning in the acquisition of goods and services and control over obligations and the use of budget authority.

- The entity incurs an **obligation**, which is the amount of orders placed, contracts awarded, services received, and similar transactions during a given period that will require payments during the same or future periods. Obligations need to comply with legal requirements before they may be properly recorded against appropriation accounts (title 7 of the *GAO Policies and Procedures Manual*). These legal requirements include consideration of 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 term "obligation" in this manual refers to orders for goods and services that have not been delivered (undelivered orders).

  The entity records **expended authority**, which is the reduction of an obligation by the receipt and acceptance of goods and services ordered.

Expended authority means that the budget authority has been used to acquire goods or services.[2]

- 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 made to liquidate obligations for goods and services. The statement of budgetary resources reconciles obligations incurred net of offsetting collections to net outlays.

- The appropriation account **expires** when, according to the restrictions contained in the appropriation, the appropriation is no longer available for new obligations. Adjustments may be made for valid obligations that were either (1) recorded at an estimated amount that differs from the actual amount[3] or (2) incurred before the authority expired, but were 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. The auditor should refer to OMB Circular A-34 (2000), sections 30.6-.10, 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 (1) canceled orders or orders for which delivery is no longer likely, (2) refunds received in the current period that relate to recovery of erroneous payments or accounting errors, (3) legal

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[2] In the normal flow of business, when obligations are incurred, a credit to "undelivered orders" or "unexpended obligations - unpaid" is recorded. When the goods or services are received, the obligation is reduced and a credit to "expended authority - unpaid" (a payable) is recorded. When the obligation is paid and the outlay is made, the transaction is credited to "expended authority - paid." For additional transaction details, see the U.S. *Standard General Ledger Accounting Transactions Supplement* of the *Treasury Financial Manual*.

[3] 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.

and valid obligations that were previously unrecorded, and (4) differences between the estimated and actual obligation amounts.

- After the 5-year period, the budget authority for the expired accounts is **canceled** and the expired accounts are **closed**. No further adjustments or outlays may be made in those closed accounts. Payments for any outstanding 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. The auditor should refer to OMB Circular A-34 (2000), sections 30.6-10, for additional guidance on these types of adjustments and transactions.

395 F - BUDGET CONTROL OBJECTIVES

.01 This section lists budget control objectives by steps in the budget process. The auditor may consider these control objectives for either or both of the audit of the statement of budgetary resources (evaluation of financial reporting controls) and/or as part of the compliance control evaluation. The auditor may evaluate many of these controls at the same time as controls over expenses, disbursements, and liabilities.

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 legislation, 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.[1]

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 considered formal/official use of budget authority. Controls over budgetary commitments are considered a type of operations control.

   The auditor should consider evaluating controls over commitments if the entity is using commitments and relying on controls over commitments to achieve the control objectives relating to obligations. If controls over commitments are evaluated, the auditor should apply the same control objectives used for obligations and expenditures, as discussed below.

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[1] 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 should notify OGC of any impoundments that come to his or her attention. OMB may also approve amounts available different from those requested by time period, activities, projects, or objects.

e. **Obligation transactions:** The following control objectives relate to obligation transactions (undelivered orders):

- **Validity:** Obligations recorded are valid. An obligation is considered valid only if it meets these criteria:

  - •• The obligation has been incurred. This is usually evidenced by appropriate supporting documentation, such as a purchase order or binding contract.

    The auditor should be alert 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 the appropriation. The auditor should be alert 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, identified in the planning phase.

  - •• The obligation has not subsequently been canceled nor the goods or services received.

  - •• For adjustments to obligations in expired accounts, the following objectives also are to be met:

- ••• If the adjustment represents a "contract change" as defined in OMB Circular A-34 (2000), the auditor should refer to section 30.7 of that circular for reporting and approval requirements.

- ••• The adjustment does not cause the entity to exceed the amount allotted or appropriated by statute.

- ••• 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.

- ••• New obligations may not be recorded in expired accounts.

- **Completeness:** All obligation transactions are recorded.

- **Valuation:** Obligations are recorded at the best available estimate of actual cost.

- **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 has multiple years. 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:** The following control objectives relating to expended authority transactions, as defined in section 395 E, are generally the same as those for obligation transactions:

- **Validity:** For all expended authority transactions, recorded expended authority transactions have occurred. This occurrence is usually evidenced by appropriate supporting documentation. For expended authority transactions (or adjustments to expended authority transactions) in expired accounts, the following objectives also are to be met:

- •• 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).

- •• The expenditure is not made out of a closed account.

- **Completeness:** All expended authority transactions and adjustments are recorded.

- **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 and by object, if applicable), including the proper appropriation year if the account has multiple years.

g. **Outlay transactions:** The following control objectives relate to outlay transactions (to be considered while auditing cash disbursements):

- **Validity:** Outlays are supported by sufficient evidence such as contractor invoices and receiving reports. The outlay is recorded against an obligation made during the period of availability of the appropriation (not made out of a closed account) and is for a purpose for which the appropriation was provided as evidenced by being 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 and should be charged to unliquidated obligations. Accrual of liabilities based on incurred but unbilled contractor costs alone is not sufficient evidence of validity (i.e., it does not ensure that the purpose, time, and amount provisions of an appropriation are met). Internal control over liquidation of the corresponding obligation by outlays is a safeguard against improper payments, including erroneous, duplicative, or fraudulent contractor billings.

- **Completeness:** All outlays and adjustments are recorded in a timely manner.

- **Classification:** Outlays are recorded in the proper accounts (both by program and by object, if applicable), including the proper appropriation year if the account has multiple years. This is evidenced by "matching" the outlay to the underlying obligation.

h. **Obligation and expended authority balances:** The following control objectives relate to obligation and expended authority balances as of a point in time:

- **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.

- **Substantiation:** Recorded account balances are supported by valid obligations and expended authority transactions.

- **Limitation:** Total undelivered orders plus total expended authority transactions do not exceed the amount of the appropriation or other statutory limitations (such as obligation ceilings) 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 outstanding unliquidated obligations that relate to closed accounts cannot exceed the limits described in A-34 (2000), section 30.10 (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 – this is a single, cumulative limit).

i. **Appropriation account balances:** The following control objectives relate to appropriation account balances as of a point in time:

- 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 USC 1553(a))

- Fixed appropriation accounts are closed on September 30th of the 5th 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 USC 1552(a)). For example, at the end of fiscal year 1995, the entity should only have accounts for fixed appropriations that expired at the end of fiscal years 1991, 1992, 1993, 1994, and 1995. All fixed appropriations that expired prior to these dates should have been closed and canceled as of the end of fiscal year 1995.

- 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 two consecutive fiscal years. (31 USC 1555)

j. **Recording of cash receipts related to closed appropriation accounts:** (to be considered only if such amounts are expected to exceed design materiality)

- 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 USC 1552(b))

395 F Sup - BUDGET CONTROL OBJECTIVES - FEDERAL CREDIT REFORM ACT SUPPLEMENT

.01 The Federal Credit Reform Act (FCRA) contains many 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 included in the notes to this supplement.) For transactions and account balances related to these types of activities, the auditor should consider each of 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 A-34 (2000), section 70, *Federal Credit Programs*. Also, see Federal Financial Accounting and Auditing Technical Release No. 3, *Preparing and Auditing Direct Loan and Loan Guarantee Subsidies Under the Federal Credit Reform Act*, issued by FASAB's Accounting and Auditing Policy Committee (AAPC) in July 1999.

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 (except modifications within the terms of existing contracts or through other existing authorities). The following are supplemental control objectives related to obligation transactions under FCRA:

- **Valuation:** Obligations are recorded at the best available estimate of actual cost.

  •• The cost of a direct loan is recorded as the net present value, at the time when the loan is disbursed, of the following cash flows:

  ••• loan disbursements,

  ••• estimated principal repayments,

  ••• estimated interest payments, and

  ••• estimated amounts and timing of any other payments by or to the government over the life of the loan. These amounts include fees, penalties, and other recoveries. Administrative costs and any incidental effects on governmental receipts and outlays are excluded. (2 USC 661a(5)(A) and (B))

These estimated cash flows include the effects of the timing and amounts of expected defaults and prepayments. These cash flows are discounted using the appropriate rate as described below.

- •• The cost of a loan guarantee is recorded as the net present value, at the time when the related guaranteed loan is disbursed, of the following cash flows:

  - ••• estimated amounts and timing of payments by the government for defaults, delinquencies, interest subsidies, or other payments, excluding administrative costs; and

  - ••• estimated amounts and timing of payments to the government for origination and other fees, penalties, and recoveries. (2 USC 661a(5)(A) and (C))

  Any incidental effects on governmental receipts and outlays are excluded. These cash flows are discounted using the appropriate rate as described below.

- •• The cost of a modification is recorded as the difference between the current estimated net present value of the cash flows under the existing direct loan or guarantee contract and the estimated net present value of the cash flows under the modified contract. The cash flows for each of these calculations is discounted at the rate for modifications described below. (2 USC 661a(5)(D))

- •• The discount rate used to estimate the net present values described above is the average interest rate, in effect when the obligation is incurred, for marketable Treasury securities of similar maturity to the related loan. For modifications, the discount rate used is the average rate, in effect at the time of modification, for marketable Treasury securities with a maturity similar to the remaining maturity of the modified loan. (2 USC 661a(5)(E))

b. **Expended authority transactions:** Expended authority transactions include transactions that occur when loans are disbursed. The following are supplemental control objectives related to expended authority transactions under FCRA:

- **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 its costs altered. (2 USC 661c(d)(2))

- **Classification/Presentation and Disclosure:** Amounts are recorded in the proper account and reported appropriately.

  - Differences in subsequent years between original estimated cost 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 USC 661c(f))

  - Funding for the administration 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 USC 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 USC 661a(7))

c. **Obligation and expended authority balances:** The following are supplemental control objectives related to obligation and expended authority balances under FCRA as of a point in time:

- **Limitation:** Total obligations plus total expended authority transactions do not exceed the amount of the appropriation or other statutory limitations that may exist by appropriation period.

- - 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. (The auditor should discuss applicability of this budget restriction to direct loans and direct loan obligations that were outstanding prior to October 1, 1991, with OGC prior to performing control or compliance tests.)

- - 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. (The auditor should discuss applicability of this budget restriction to loan guarantees, or loan guarantee commitments that were outstanding prior to October 1, 1991, with OGC prior to performing control or compliance tests.)

d. **Cash receipts:** The following are supplemental control objectives related to cash receipts under FCRA:

- **Classification:** Cash receipts are recorded in the proper account.

  - - Cash receipts related to direct loans obligated or loan guarantees committed prior to October 1, 1991, are recorded in the liquidating accounts. (2 USC 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 USC 661a(7))

Note 1: A **direct loan** is a disbursement of funds by the government to a nonfederal borrower under a contract that requires the repayment of such funds with or without interest. The term also includes the purchase of, or participation in, a loan made by another lender. The term does not include the acquisition of a federally guaranteed loan in satisfaction of default claims or the price support loans of the Commodity Credit Corporation. (2 USC 661a(1))

Note 2: A **direct loan obligation** is a binding agreement by a federal agency to make a direct loan when specified conditions are fulfilled by the borrower. (2 USC 661a(2))

Note 3: A **loan guarantee** is any guarantee, insurance, or other pledge with respect to the payment of all or a part of the principal or interest on any debt obligation of a nonfederal borrower to a nonfederal lender, but does not include the insurance of deposits, shares, or other withdrawable accounts in financial institutions. (2 USC 661a(3))

Note 4: A **loan guarantee commitment** is a binding agreement by a federal agency to make a loan guarantee when specified conditions are fulfilled by the borrower, the lender, or any other party to the guarantee agreement. (2 USC 661a(4))

Note 5: **Costs** are 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 USC 661a(5)). These calculations are described in further detail under the valuation control objective for obligations in FAM 395 F.

Note 6: A **credit program account** is a budget account associated with each program account into which an appropriation to cover the cost of a direct loan or loan guarantee program is made and from which such cost is disbursed to the financing account. (2 USC 661a(6))

Note 7: A **liquidating account** is a budget account that includes 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 required to be shown on a cash basis. (2 USC 661a(8))

Note 8: A **financing account** is a nonbudget account(s) associated with each credit program account that holds balances, receives the cost payment from the credit program account, and also includes 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 USC 661a(7))

Note 9: **Modifications** are government actions that alter the estimated cost of an outstanding direct loan or loan guarantee from the current estimate of cash flows (2 USC 661c(9)); for example, a policy change affecting the repayment period or interest rate for a group of existing loans. Changes within the terms of existing contracts or through other existing authorities are not considered 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 considered modifications. The effects of these changes should be included in the annual reestimates of the estimated net present value of the obligations.

Note 10: OMB Circular A-34, section 70.2(x) instructs agencies to make annual **reestimates** 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 the timing of payments. Permanent indefinite authority has been provided for reestimates.

395 G - ROTATION TESTING OF CONTROLS

OVERVIEW

.01 Rotation testing of controls, as discussed in paragraph 380.01, may be considered for testing financial reporting controls of an entity with multiple significant accounting cycles/applications, provided that effective financial reporting controls within all significant cycles/applications have been evaluated and tested within a sufficiently recent period of years. Under a rotation plan, such controls are tested in different cycles/applications each year such that each cycle/application is selected for testing, as described in sections 310-380, at least once during a rotation period of several years, but not necessarily every year. For example, a rotation plan for an entity with five significant cycles/applications might include tests of two or three cycles/applications annually, covering all cycles/applications in a two or three year period. Rotation testing should be limited to computerized applications that have strong computer general controls because computer programs ordinarily function consistently in the absence of programming changes, reducing the probability of random errors.

.02 Less extensive work must be performed annually for financial reporting controls in significant cycles/applications not selected for testing. This work consists of

- updating the auditor's understanding of the control environment, risk assessment, communication, and monitoring, accounting system, and financial reporting control activities, including performing walkthroughs, and
- performing any other procedures that may be necessary under the specific circumstances to support the report on internal control and the evaluation of internal controls relied on in performing certain audit procedures.

.03 The auditor's decision to use rotation is made on a cycle-by-cycle or application-by-application basis, so some cycles/applications might be tested annually and others by rotation. In rotation testing, the auditor relies on cumulative audit evidence and knowledge, including that gathered in prior years, to support the assessment of and report on internal control.

Accordingly, rotation may be used only when all the following conditions exist:

- The auditor possesses a "foundation" of audit evidence on which to develop current audit conclusions.

- Control risk is low; the control environment, risk assessment, communication, and monitoring are strong; and inherent and fraud risk factors are reasonably low.

- Financial reporting controls over all significant cycles/applications have been evaluated and tested during a sufficiently recent period (generally within 3 years).

- Recurring audits of the entity enable a rotation plan to be effective.

- No specific reporting or risk issues preclude the use of rotation. (For example, cycles/applications do not affect such sensitive areas as loan loss reserves.)

.04 Ordinarily, the following cycles/applications should be subjected to tests of financial reporting controls and should be excluded from rotation testing:

- any cycle/application that is disproportionately significant.

- any cycle/application that has undergone major change since financial reporting controls were most recently tested.

The auditor should consider whether assets susceptible to loss or theft, such as cash on hand or imprest funds, also should be excluded from rotational testing.

.05 The foundation of audit evidence to support a rotation plan, which is updated and increased through limited tests and other relevant audit evidence, may be obtained from one or a combination of the following:

- evidence gathered in one or more prior audits and

- the current or prior work of another auditor, after the auditor considers the requirements of FAM section 650.

CIRCUMSTANCES UNDER WHICH ROTATION TESTING MAY BE USED

.06 The auditor should exercise judgment in determining whether to use rotation. Factors that the auditor should consider include the following:

- The results and extent of the auditor's prior experiences with the entity and its cycles/applications, including the length of time since financial reporting controls were tested.

  The effectiveness of prior evidence ordinarily diminishes with the passage of time.

- The importance of the cycles/applications to the overall entity and the nature of the audit assertion or assertions involved.

  As the significance of cycles/applications and assertions increases, the frequency of testing thereof ordinarily increases.

- The auditor's assessment of inherent and fraud risk.

  The effectiveness of rotation ordinarily diminishes as inherent and fraud risk increase.

- The auditor's preliminary assessment of control risk.

  The effectiveness of rotation ordinarily diminishes rapidly as control risk increases.

- The extent to which control is centralized or decentralized.

  The effectiveness of rotation ordinarily diminishes rapidly as control becomes more decentralized.

- The number and relative sizes of the respective cycles/applications.

  The efficiency of rotation ordinarily increases as the number and size of cycles/applications increase.

- The nature and extent of audit evidence about internal controls that may result from substantive testing in the current audit.

  Information obtained concurrently with substantive testing might provide evidence about the functioning of cycles/applications.

- The extent of oversight provided by others.

  Work performed by others might be used to reduce tests of financial reporting controls. (See FAM section 650.)

- Any special reporting or entity requirements.

  The auditor should perform sufficient tests to meet any special requirements, such as a special report on the functioning of a specific cycle/application.

.07 For any rotation testing plan, the auditor should document in a memorandum approved by the Reviewer

- the schedule for testing all significant cycles/applications;
- the reasons for using such a plan;
- any limitations on the use of such a plan; and
- any other significant aspects, including descriptions of any modifications to rotation plans established in previous years. A rotation plan should be reevaluated annually.

395 H - SPECIFIC CONTROL EVALUATION WORKSHEET

The auditor should use the SCE worksheet or equivalent to document the evaluation of control activities in the internal control phase. This section illustrates an SCE worksheet for the cash receipts application for a hypothetical federal government entity, "XYZ Agency" (XYZ). (See page 395 H-3.)

An SCE worksheet should be prepared for each significant accounting application. The auditor generally should use the SCE worksheet to document the evaluation of compliance (including budget) and operations controls. The worksheet may be completed for financial reporting controls as follows:

1. List each assertion that is relevant to the accounting application. While all five financial statement assertions relate to line item/account-related accounting applications, the existence or occurrence, completeness, and valuation assertions relate principally to transaction-related accounting applications, as illustrated at section 395 B. Therefore, assertions relevant to cash receipts would be existence or occurrence, completeness, and valuation.

2. From the Account Risk Analysis (see section 240), list the significant line items or accounts that the accounting application affects. For example, cash and accounts receivable are ordinarily affected by cash receipts.

3. Document the assertions for each of the line items or accounts identified in step 2 that relate to each accounting application assertion (see section 330).

4. For each significant account assertion, identify the potential misstatements that could occur in the accounting application and the related control objectives, based on the generic list of potential misstatements and control objectives included in section 395 B. This list should be tailored to the accounting application and the entity and, if

necessary, should be supplemented with additional objectives or subobjectives.[1]

5. List control activities selected for testing that achieve each control objective identified above and indicate whether each is an IS control. Section 395 C illustrates typical control activities to achieve financial reporting control objectives. User controls where the user would be able to detect misstatements in the computer-generated information independently of IS is not an IS control.

6. Document the effectiveness of control activities in achieving the control objectives in relation to each potential misstatement and cross-reference to the audit procedures in the testing program. (The overall assessment of financial reporting controls should be documented in the ARA document, as illustrated in section 395 I.)

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[1] In the SCE worksheet, the auditor may either commingle the documentation of compliance (including budget) and operations controls with that of financial reporting controls to the extent relevant or present each of these types of controls in a separate SCE. To complete the SCE worksheet for these controls, the auditor begins by inserting relevant control objectives and performs steps 5 and 6 above.

ENTITY: *XYZ Agency (XYZ)* ______ **SPECIFIC CONTROL EVALUATION** PREPARER ______

DATE OF FIN. STMTS: *9/30/92* ______ FILE: ______ REGION ______

ACCOUNTING APPLICATION: *Cash Receipts* ______ DATE ______ Page ___ of ___

ACCOUNTING APPLICATION: CASH RECEIPTS

ACCOUNTING APPLICATION ASSERTION	RELEVANT ASSERTIONS IN RELATED GROUPS OF ACCOUNTS		POTENTIAL MISSTATEMENT IN ACCOUNTING APPLICATION ASSERTIONS	CONTROL OBJECTIVES	INTERNAL CONTROL ACTIVITIES	IS (Y/N)	EFFECTIVE-NESS OF CONTROL ACTIVITIES	W/P REF. & CONTROL TESTING PROGRAM STEP
	Cash	*Accts. Rec.*						
Existence or Occurrence	*Existence or Occurrence*	*Completeness*	*Validity:* *1. Receipt is recorded, but cash is not received.*	*1a. Recorded cash receipts and cash receipt processing procedures should be authorized by federal laws, regulations, and management's policy.*	*1a. Receipts processing is governed by documented procedures for accepting, obtaining, reviewing, and approving receipts.*	*N*	*Effective*	[In this column, the auditor would indicate, by cross-referencing, the audit procedures in the detailed control testing audit program that were designed to test each effective control determined to be relevant. Such tests will involve inquiry, observation, inspection, or a combination thereof.]
				1b. Recorded receipts should be approved by appropriate individuals in accordance with management's general or specific criteria.	*1b. Supervisory review is made of receipts processing to provide reasonable assurance that procedures are followed.*	*N*		
				1c. Recorded receipts should represent amounts actually received by the entity and should be properly classified.	*$1c_{1.}$ Recorded cash receipts are matched with the appropriate supporting documentation.*	*N*		
					$1c_{2.}$ Entries to the accounting records are reviewed and approved by supervisory personnel.	*N*		

ENTITY: *XYZ Agency (XYZ)*	**SPECIFIC CONTROL EVALUATION**	PREPARER ____________
DATE OF FIN. STMTS: *9/30/92*	FILE: ______	REGION ______________
ACCOUNTING APPLICATION: *Cash Receipts*		DATE ________________ Page ___ of ___

ACCOUNTING APPLICATION: CASH RECEIPTS

ACCOUNTING APPLICATION ASSERTION	RELEVANT ASSERTIONS IN RELATED GROUPS OF ACCOUNTS		POTENTIAL MISSTATEMENT IN ACCOUNTING APPLICATION ASSERTIONS	CONTROL OBJECTIVES	INTERNAL CONTROL ACTIVITIES	IS (Y/N)	EFFECTIVE-NESS OF CONTROL ACTIVITIES	W/P REF. & CONTROL TESTING PROGRAM STEP
	Cash	*Accts. Rec.*						
			Cutoff: *2. Receipt is recorded in this period, but the cash is received in a different period.*	*2. Cash receipts recorded in the period should be actually received in the period.*	*2. Recorded receipts are reconciled to cash receipts listings and bank deposit reports before posting.*	*Y*	*Effective*	
			Summarization: *3. Receipt transactions are overstated due to improper summarization.*	*3. The summarization of receipt transactions should not be overstated.*	*3a. Receipt data in the general ledger is reconciled to subsidiary cash ledgers and records.*	*Y*	*Effective*	
					3b. Batch totals of input documents are reconciled to output registers, journals, reports, or file updates.	*Y*		

ENTITY: *XYZ Agency (XYZ)*

DATE OF FIN. STMTS: *9/30/92*

ACCOUNTING APPLICATION: *Cash Receipts*

SPECIFIC CONTROL EVALUATION

FILE: ______

PREPARER ____________

REGION ______________

DATE ________________ Page __ of __

ACCOUNTING APPLICATION: CASH RECEIPTS

ACCOUNTING APPLICATION ASSERTION	RELEVANT ASSERTIONS IN RELATED GROUPS OF ACCOUNTS		POTENTIAL MISSTATEMENT IN ACCOUNTING APPLICATION ASSERTIONS	CONTROL OBJECTIVES	INTERNAL CONTROL ACTIVITIES	IS (Y/N)	EFFECTIVE-NESS OF CONTROL ACTIVITIES	W/P REF. & CONTROL TESTING PROGRAM STEP
	Cash	*Accts. Rec.*						
Completeness	*Completeness*	*Existence or Occurrence*	*Transaction Completeness:* *4. Cash is received, but receipt is not recorded.*	*4. All receipts of cash should be promptly recorded and properly classified.*	*4a. Cash receipts are listed by the central mailroom staff and independently reconciled to deposits and accounting summaries, providing adequate segregation of duties. Collections and complaints are handled by others.*	*N*	*Effective*	
					4b. Supervisory reviews of the processing of cash receipts.	*N*		
			Cutoff: *5. Cash is received in this period, but receipt is recorded in a different period.*	*5. Cash receipts actually received in the period should be recorded in the period.*	*5. Same as procedure 2 above.*	*Y*	*Effective*	
			Summarization: *6. Receipt transactions are understated as a result of improper summarization.*	*6. The summarization of cash receipt transactions should not be understated.*	*6. Same as procedure 3a and 3b above.*	*Y*	*Effective*	

ENTITY: *XYZ Agency (XYZ)*

SPECIFIC CONTROL EVALUATION

PREPARER ______

DATE OF FIN. STMTS: *9/30/92*

FILE: ______

REGION ______

ACCOUNTING APPLICATION: *Cash Receipts*

DATE ______ Page ___ of ___

ACCOUNTING APPLICATION: CASH RECEIPTS

ACCOUNTING APPLICATION ASSERTION	RELEVANT ASSERTIONS IN RELATED GROUPS OF ACCOUNTS		POTENTIAL MISSTATEMENT IN ACCOUNTING APPLICATION ASSERTIONS	CONTROL OBJECTIVES	INTERNAL CONTROL ACTIVITIES	IS (Y/N)	EFFECTIVE-NESS OF CONTROL ACTIVITIES	W/P REF. & CONTROL TESTING PROGRAM STEP
	Cash	*Accts. Rec.*						
Valuation	*Valuation*	*Valuation*	*Accuracy:* *7. Receipt transactions are recorded at incorrect amounts.*	*7. Receipt transactions should be recorded accurately.*	*7a. Recorded receipts are compared with bank statements by persons who have no other receipts processing responsibilities.*	*Y*	*Effective*	
					7b. Supervisor reviews and approves reconciliations of recorded receipts to bank statements.	*N*		

ENTITY: *XYZ Agency (XYZ)* SPECIFIC CONTROL EVALUATION PREPARER ____________

DATE OF FIN. STMTS: *9/30/92* FILE: ______ REGION ______________

ACCOUNTING APPLICATION: *Cash Receipts* DATE ______________ Page __ of __

ACCOUNTING APPLICATION: CASH RECEIPTS

ACCOUNTING APPLICATION ASSERTION	RELEVANT ASSERTIONS IN RELATED GROUPS OF ACCOUNTS		POTENTIAL MISSTATEMENT IN ACCOUNTING APPLICATION ASSERTIONS	CONTROL OBJECTIVES	INTERNAL CONTROL ACTIVITIES	IS (Y/N)	EFFECTIVE-NESS OF CONTROL ACTIVITIES	W/P REF. & CONTROL TESTING PROGRAM STEP
	Cash	*Accts. Rec.*						
Segregation of Duties	*Various*	*Various*	*Segregation* *8. The entity is exposed to loss of cash receipts and various misstatements as the result of inadequate segregation of duties.*	*8. Persons should be prevented from having uncontrolled access to both cash receipts and records.*	*8a. No individual has uncontrolled access (direct or indirect) to both cash receipts and records.*	*N*	*Effective*	

Preparation Notes:

1. The third column is for use where the effects of the accounting application on the line items are different. For example, misstatements in the existence or occurrence assertion for cash receipts typically result in misstatements in the existence or occurrence assertion for cash and in the completeness assertion for accounts receivable (see paragraph 330.05).

2. If there is inadequate segregation of duties, the auditor should identify the specific affected account assertions in columns 2 and 3.

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395 I - ACCOUNT RISK ANALYSIS FORM

.01 The ARA form or equivalent should be used by the auditor to summarize, for significant line items, specific risks of misstatement for consideration in determining the nature, timing, and extent of audit procedures. Any pervasive risks should be documented in the GRA and considered when designing audit procedures but do not need to be documented on the ARA form. An ARA form should be prepared for each significant line item and should identify the significant accounts and related assertions.

.02 The form may be completed as the related activities are performed as follows:

Planning Phase:

1. List each significant account, account balance, and related significant financial statement assertions as discussed in section 235. Accounts that share the same risks and applications generally should be grouped together. As noted in paragraph 290.06, insignificant accounts may be listed following the significant accounts. This would allow the auditor to add all account balances to the line item total and demonstrate that such balances are insignificant. In such cases, the cycle matrix is not necessary.

2. For each financial statement assertion, describe the related risk (see section 260).

3. From the GRA, summarize any specific inherent, fraud, or control risk factors identified.

4. List the significant cycles and accounting applications that affect each assertion.

Internal Control Phase:

5. For each cycle and accounting application, indicate the assessment of the effectiveness of the related control activities for the assertion. This assessment should be obtained from the related SCE worksheet.

6. Assess the control risk for each assertion (see section 370) and document the assessment.

7. Assess the combined risk for each assertion (see section 370) and document the assessment.

Testing Phase:

8. Determine the nature, timing, and extent of audit procedures (see sections 420 and 430). Document a brief description of the procedure and reference to the step of the detailed audit program.

9. If the results of testing indicate that the preliminary assessments of control risk or combined risk were not appropriate, the revised assessments and a summary of the factors contributing to the revised assessment should be documented on the ARA and described in a memorandum, as appropriate.

.03 Insignificant line items and accounts also may be documented on the ARA form rather than in the cycle matrix. Regardless, the auditor should determine and document that <u>all</u> accounts have been considered in the audit plan.

ENTITY: *XYZ Agency (XYZ)* ______________ **ACCOUNT RISK ANALYSIS FORM** PREPARER____________

DATE OF FINANCIAL STATEMENTS: *9/30/92* REGION ______________

FILE: _______

LINE ITEM: *Accounts Receivable - Net* _______ DATE _______________ Page __ of __

PLANNING PHASE					INTERNAL CONTROL PHASE			TESTING PHASE		
Account		Financial Statement Assertions/Risks	Inherent, Fraud, and Control Risk Factors	Cycle/ Accounting Application	Effective-ness of Control Activities	Control Risk	Combined Risk	Timing I/F	Nature & Extent	W/P Ref.& Audit Step
Name	Balance									
Accounts Receivable-Net	*$876,000,000*	***Existence or Occurrence:*** *Recorded accounts receivable do not exist.*	*No significant inherent, fraud, or control risk factors identified.*	*Sales/ Billing*	*Effective*	*Low*	*Low*	*F*	*Confirm balances and test reconciliation of subsidiary ledger to the general ledger.*	*III-5 to III-7*
				Sales Returns	*Effective*					
				Cash Receipts	*Effective*					
				Accounts Receivable	*Effective*					

ENTITY: *XYZ Agency (XYZ)*

DATE OF FINANCIAL STATEMENTS: *9/30/92*

LINE ITEM: *Accounts Receivable - Net*

ACCOUNT RISK ANALYSIS FORM

FILE: ______

PREPARER ______

REGION ______

DATE ______

Page __ of __

PLANNING PHASE					INTERNAL CONTROL PHASE			TESTING PHASE		
Account		Financial Statement Assertions/Risks	Inherent, Fraud, and Control Risk Factors	Cycle/ Accounting Application	Effective-ness of Control Activities	Control Risk	Combined Risk	Timing I/F	Nature & Extent	W/P Ref.& Audit Step
Name	Balance									
		Completeness: *Accounts receivable are not recorded in a timely manner so as to be included in the financial statements.*	*No significant inherent, fraud, or control risk factors identified.*	*Sales/ Billing*	*Effective*	*Low*	*Low*	*F*	*Perform analytical procedures. Test cut-off.*	*III-8 to III-12*
				Sales Returns	*Effective*					
				Cash Receipts	*Effective*					
				Accounts Receivable	*Effective*					

ENTITY: *XYZ Agency (XYZ)* PREPARER____________

DATE OF FINANCIAL STATEMENTS: *9/30/92* REGION ______________

LINE ITEM: *Accounts Receivable - Net* DATE ________________ Page __ of __

ACCOUNT RISK ANALYSIS FORM

FILE: _______

PLANNING PHASE					INTERNAL CONTROL PHASE			TESTING PHASE		
Account		Financial Statement Assertions/Risks	Inherent, Fraud, and Control Risk Factors	Cycle/ Accounting Application	Effective-ness of Control Activities	Control Risk	Combined Risk	Timing I/F	Nature & Extent	W/P Ref.& Audit Step
Name	Balance									
		***Valuation or Allocation*:** *Accounts receivable are not valued accurately or on an appropriate basis in the financial statements.*	*The bankruptcy filing by a major debtor and the financial difficulties of several other debtors in the current economic environment give rise to an inherent risk. No significant fraud or control risk factors identified.* .	*Sales/ Billing* *Sales Return* *Cash Receipts* *Accounts Receivable*	*Effective* *Effective* *Effective* *Effective*	*Low*	*Moderate*	*F*	*Confirm balances (see existence), test the accuracy of the aging, analytically review bad debts and allowance, and examine evidence of collectibility for selected accounts receivable. Discuss with management collectibility from troubled debtors.*	*III-13 to III-18*

ENTITY: *XYZ Agency (XYZ)* ______

DATE OF FINANCIAL STATEMENTS: *9/30/92*

LINE ITEM: *Accounts Receivable - Net* ______

ACCOUNT RISK ANALYSIS FORM

FILE: ______

PREPARER______

REGION ______

DATE ______ Page __ of __

PLANNING PHASE					INTERNAL CONTROL PHASE			TESTING PHASE		
Account		Financial Statement Assertions/Risks	Inherent, Fraud, and Control Risk Factors	Cycle/ Accounting Application	Effective-ness of Control Activities	Control Risk	Combined Risk	Timing I/F	Nature & Extent	W/P Ref.& Audit Step
Name	Balance									
		***Rights and Obligations**:* *XYZ does not own unencumbered rights to recorded accounts receivable.*	*No significant inherent, fraud, or control risk factors identified.*	*Accounts Receivable*	*Effective*	*Low*	*Low*	*F*	*Identify accounts receivable from related parties or major debtors. Review confirmations for indication of guarantees or encumbrances.*	*III-19 to III-22*

ENTITY: *XYZ Agency (XYZ)*	ACCOUNT RISK ANALYSIS FORM	PREPARER____________
DATE OF FINANCIAL STATEMENTS: *9/30/92*	FILE: _______	REGION ______________
LINE ITEM: *Accounts Receivable - Net*		DATE ________________ Page __ of __

PLANNING PHASE					INTERNAL CONTROL PHASE			TESTING PHASE		
Account		Financial Statement Assertions/Risks	Inherent, Fraud, and Control Risk Factors	Cycle/ Accounting Application	Effective-ness of Control Activities	Control Risk	Combined Risk	Timing I/F	Nature & Extent	W/P Ref.& Audit Step
Name	Balance									
		Presentation and Disclosure: *Accounts receivable are not properly classified or disclosed in the financial statements, nor are they based on a consistent application of accounting principles.*	*No significant inherent, fraud, or control risk factors identified.*	*Accounts Receivable*	*Effective*	*Low*	*Low*	*F*	*Determine appropriateness of footnote disclosures. Summarize and test credit risk disclosures. Review accounting principles used.*	*III-23 to III-25, IV-16*
Line Item Total	*$876,000,000*									

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