

## AU Section 801

### *Compliance Audits*

(Supersedes SAS No. 74.)

Source: SAS No. 117.

Effective for compliance audits for fiscal periods ending on or after June 15, 2010.  
Earlier application is permitted.

### Introduction and Applicability

**.01** Governments frequently establish governmental audit requirements for entities to undergo an audit of their compliance with applicable compliance requirements. This section is applicable when an auditor is engaged, or required by law or regulation, to perform a compliance audit in accordance with all of the following:

- Generally accepted auditing standards (GAAS)
- The standards for financial audits under *Government Auditing Standards*
- A governmental audit requirement that requires an auditor to express an opinion on compliance (Ref: par. .A1–.A2)

**.02** This section addresses the application of GAAS to a compliance audit. Compliance audits usually are performed in conjunction with a financial statement audit. This section does not apply to the financial statement audit component of such engagements. Although certain AU sections are not applicable to a compliance audit, as identified in the appendix of this section, all AU sections other than section 801 are applicable to the audit of financial statements performed in conjunction with a compliance audit.

**.03** This section is not applicable when the governmental audit requirement calls for an examination, in accordance with Statements on Standards for Attestation Engagements, of an entity's compliance with specified requirements or an examination of an entity's internal control over compliance. AT section 601, *Compliance Attestation*, is applicable to these engagements. If the entity is required to undergo a compliance audit and an examination of internal control over compliance, this section is applicable to performing and reporting on the compliance audit, and AT section 601 is applicable to performing and reporting on the examination of internal control over compliance. (Ref: par. .A2)

**.04** Sections 100–700 and 900 address audits of financial statements, as well as other kinds of engagements. Sections 100–300 and 500 generally can be adapted to the objectives of a compliance audit. However, with certain exceptions, sections 400, 600, 700, and 900 generally cannot be adapted to a compliance audit because they address the auditor's report on an audit of financial statements and other topics that are not applicable to a compliance audit.

**.05** The AU sections that are not applicable to a compliance audit are listed in the appendix of this section. All of the other AU sections are applicable to

a compliance audit. However, the auditor is not required, in planning and performing a compliance audit, to make a literal translation of each procedure that might be performed in a financial statement audit, but rather to obtain sufficient appropriate audit evidence to support the auditor's opinion on compliance.

**.06** Some AU sections can be adapted and applied to a compliance audit with relative ease, for example, by simply replacing the word *misstatement* with the word *noncompliance*. Other AU sections are more difficult to adapt and apply and entail additional modification. For that reason, this section provides more specific guidance on how to adapt and apply certain AU sections to a compliance audit.

**.07** *Government Auditing Standards* and governmental audit requirements contain certain standards and requirements that are supplementary to those in GAAS, as well as guidance on how to apply those standards and requirements.

## Management's Responsibilities

**.08** A compliance audit is based on the premise that management is responsible for the entity's compliance with compliance requirements. Management's responsibility for the entity's compliance with compliance requirements includes the following:

- a. Identifying the entity's government programs and understanding and complying with the compliance requirements
- b. Establishing and maintaining effective controls that provide reasonable assurance that the entity administers government programs in compliance with the compliance requirements
- c. Evaluating and monitoring the entity's compliance with the compliance requirements
- d. Taking corrective action when instances of noncompliance are identified, including corrective action on audit findings of the compliance audit

## Effective Date

**.09** The provisions of this section are effective for compliance audits for fiscal periods ending on or after June 15, 2010. Earlier application is permitted.

## Objectives (Ref: par. .A3)

**.10** The auditor's objectives in a compliance audit are to

- a. obtain sufficient appropriate audit evidence to form an opinion and report at the level specified in the governmental audit requirement on whether the entity complied in all material respects with the applicable compliance requirements; and
- b. identify audit and reporting requirements specified in the governmental audit requirement that are supplementary to GAAS and *Government Auditing Standards*, if any, and perform procedures to address those requirements.

## Definitions

.11 For the purpose of adapting GAAS to a compliance audit, the following terms have the meanings attributed as follows:

**Applicable compliance requirements.** Compliance requirements that are subject to the compliance audit.

**Audit findings.** The matters that are required to be reported by the auditor in accordance with the governmental audit requirement.

**Audit risk of noncompliance.** The risk that the auditor expresses an inappropriate audit opinion on the entity's compliance when material noncompliance exists. Audit risk of noncompliance is a function of the risks of material noncompliance and detection risk of noncompliance.

**Compliance audit.** A program-specific audit or an organization-wide audit of an entity's compliance with applicable compliance requirements.

**Compliance requirements.** Laws, regulations, rules, and provisions of contracts or grant agreements applicable to government programs with which the entity is required to comply.

**Deficiency in internal control over compliance.** A deficiency in internal control over compliance exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance on a timely basis.

A deficiency in *design* exists when a control necessary to meet the control objective is missing or an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met.

A deficiency in *operation* exists when a properly designed control does not operate as designed or the person performing the control does not possess the necessary authority or competence to perform the control effectively.

**Detection risk of noncompliance.** The risk that the procedures performed by the auditor to reduce audit risk of noncompliance to an acceptably low level will not detect noncompliance that exists and that could be material, either individually or when aggregated with other instances of noncompliance.

**Governmental audit requirement.** A government requirement established by law, regulation, rule, or provision of contracts or grant agreements requiring that an entity undergo an audit of its compliance with applicable compliance requirements related to one or more government programs that the entity administers. (Ref: par. .A4)

**Government Auditing Standards.** Standards and guidance issued by the Comptroller General of the United States, U.S. Government Accountability Office for financial audits, attestation engagements, and performance audits. *Government Auditing Standards* also is known as generally accepted government auditing standards (GAGAS) or the Yellow Book.

**Government program.** The means by which governmental entities achieve their objectives. For example, one of the objectives of the U.S. Department of Agriculture is to provide nutrition to individuals in need. Examples of government programs designed to achieve that objective are the Supplemental Nutrition Assistance Program and the National School Lunch Program. Government programs that are relevant to this section are those in which a grantor or pass-through entity provides an award to another entity, usually in the form of a grant, contract, or other agreement. Not all government programs provide cash assistance; sometimes noncash assistance is provided (for example, a loan guarantee, commodities, or property).

**Grantor.** A government agency from which funding for the government program originates.

**Known questioned costs.** Questioned costs specifically identified by the auditor. Known questioned costs are a subset of likely questioned costs.

**Likely questioned costs.** The auditor's best estimate of total questioned costs, not just the known questioned costs. Likely questioned costs are developed by extrapolating from audit evidence obtained, for example, by projecting known questioned costs identified in an audit sample to the entire population from which the sample was drawn.

**Material noncompliance.** In the absence of a definition of material noncompliance in the governmental audit requirement, a failure to follow compliance requirements or a violation of prohibitions included in the applicable compliance requirements that results in noncompliance that is quantitatively or qualitatively material, either individually or when aggregated with other noncompliance, to the affected government program.

**Material weakness in internal control over compliance.** A deficiency, or combination of deficiencies, in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a compliance requirement will not be prevented, or detected and corrected, on a timely basis. In this section, a reasonable possibility exists when the likelihood of the event is either reasonably possible or probable as defined as follows:

**Reasonably possible.** The chance of the future event or events occurring is more than remote but less than likely.

**Remote.** The chance of the future event or events occurring is slight.

**Probable.** The future event or events are likely to occur.

**Organization-wide audit.** An audit of an entity's financial statements and an audit of its compliance with the applicable compliance requirements as they relate to one or more government programs that the entity administers.

**Pass-through entity.** An entity that receives an award from a grantor or other entity and distributes all or part of it to another entity to administer a government program.

**Program-specific audit.** An audit of an entity's compliance with applicable compliance requirements as they relate to one government program that the entity administers. The compliance audit portion of a program-specific audit is performed in conjunction with either an audit of the entity's or the program's financial statements.

**Questioned costs.** Costs that are questioned by the auditor because (1) of a violation or possible violation of the applicable compliance requirements, (2) the costs are not supported by adequate documentation, or (3) the incurred costs appear unreasonable and do not reflect the actions that a prudent person would take in the circumstances.

**Risk of material noncompliance.** The risk that material noncompliance exists prior to the audit. This consists of two components, described as follows:

**Inherent risk of noncompliance.** The susceptibility of a compliance requirement to noncompliance that could be material, either individually or when aggregated with other instances of noncompliance, before consideration of any related controls over compliance.

**Control risk of noncompliance.** The risk that noncompliance with a compliance requirement that could occur and that could be material, either individually or when aggregated with other instances of noncompliance, will not be

prevented, or detected and corrected, on a timely basis by the entity's internal control over compliance.

**Significant deficiency in internal control over compliance.** A deficiency, or a combination of deficiencies, in internal control over compliance that is less severe than a material weakness in internal control over compliance, yet important enough to merit attention by those charged with governance.

## Requirements

### Adapting and Applying the AU Sections to a Compliance Audit (Ref: par. .A5 and .A38)

.12 When performing a compliance audit, the auditor, using professional judgment, should adapt and apply the AU sections to the objectives of a compliance audit, except for the AU sections listed in the appendix of this section.

### Establishing Materiality Levels (Ref: par. .A6–.A8)

.13 The auditor should establish and apply materiality levels for the compliance audit based on the governmental audit requirement.

### Identifying Government Programs and Applicable Compliance Requirements (Ref: par. .A9–.A11)

.14 As discussed in paragraph .08, a compliance audit is based on the premise that management is responsible for identifying the entity's government programs and understanding and complying with the compliance requirements. The auditor should determine which of those government programs and compliance requirements to test (that is, the applicable compliance requirements) in accordance with the governmental audit requirement.

### Performing Risk Assessment Procedures (Ref: par. .A12–.A15)

.15 For each of the government programs and applicable compliance requirements selected for testing, the auditor should perform risk assessment procedures to obtain a sufficient understanding of the applicable compliance requirements and the entity's internal control over compliance with the applicable compliance requirements.<sup>1</sup>

.16 In performing risk assessment procedures, the auditor should inquire of management about whether there are findings and recommendations in reports or other written communications resulting from previous audits, attestation engagements, and internal or external monitoring that directly relate to the objectives of the compliance audit. The auditor should gain an understanding of management's response to findings and recommendations that could have a material effect on the entity's compliance with the applicable compliance requirements (for example, taking corrective action). The auditor should use this information to assess risk and determine the nature, timing, and extent of the audit procedures for the compliance audit, including determining the extent to which testing the implementation of any corrective actions is applicable to the audit objectives.

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<sup>1</sup> See paragraphs .01–.08, .10–.43, .46–.82, and .87–.101 of section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.

## Assessing the Risks of Material Noncompliance (Ref: par. .A16–.A18)

.17 The auditor should assess the risks of material noncompliance whether due to fraud or error for each applicable compliance requirement and should consider whether any of those risks are pervasive to the entity's compliance because they may affect the entity's compliance with many compliance requirements.<sup>2</sup>

## Performing Further Audit Procedures in Response to Assessed Risks

.18 If the auditor identifies risks of material noncompliance that are pervasive to the entity's compliance, the auditor should develop an overall response to such risks. (Ref: par. .A19)

.19 The auditor should design and perform further audit procedures, including tests of details (which may include tests of transactions) to obtain sufficient appropriate audit evidence about the entity's compliance with each of the applicable compliance requirements in response to the assessed risks of material noncompliance. Risk assessment procedures, tests of controls, and analytical procedures alone are not sufficient to address a risk of material noncompliance. (Ref: par. .A20–.A23)

.20 The auditor should design and perform further audit procedures in response to the assessed risks of material noncompliance. These procedures should include performing tests of controls over compliance if

- the auditor's risk assessment includes an expectation of the operating effectiveness of controls over compliance related to the applicable compliance requirements;
- substantive procedures alone do not provide sufficient appropriate audit evidence; or
- such tests of controls over compliance are required by the governmental audit requirement.

If any of the conditions in this paragraph are met, the auditor should test the operating effectiveness of controls over each applicable compliance requirement to which the conditions apply in each compliance audit. (Ref: par. .A24–.A25)

## Supplementary Audit Requirements

.21 The auditor should determine whether audit requirements are specified in the governmental audit requirement that are supplementary to GAAS and *Government Auditing Standards* and perform procedures to address those requirements, if any. (Ref: par. .A26)

.22 In instances where audit guidance provided by a governmental agency for the performance of compliance audits has not been updated for, or otherwise conflicts with, current GAAS or *Government Auditing Standards*, the auditor should comply with the most current applicable GAAS and *Government Auditing Standards* instead of the outdated or conflicting guidance. (Ref: par. .A27)

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<sup>2</sup> See paragraphs .103–.121 of section 314.

## Written Representations

**.23** The auditor should request from management written representations<sup>3</sup> that are tailored to the entity and the governmental audit requirement: (Ref: par. .A28)

- a. acknowledging management's responsibility for understanding and complying with the compliance requirements;
- b. acknowledging management's responsibility for establishing and maintaining controls that provide reasonable assurance that the entity administers government programs in accordance with the compliance requirements;
- c. stating that management has identified and disclosed to the auditor all of its government programs and related activities subject to the governmental audit requirement;
- d. stating that management has made available to the auditor all contracts and grant agreements, including amendments, if any, and any other correspondence relevant to the programs and related activities subject to the governmental audit requirement;
- e. stating that management has disclosed to the auditor all known noncompliance with the applicable compliance requirements or stating that there was no such noncompliance;
- f. stating whether management believes that the entity has complied with the applicable compliance requirements (except for noncompliance it has disclosed to the auditor);
- g. stating that management has made available to the auditor all documentation related to compliance with the applicable compliance requirements;
- h. identifying management's interpretation of any applicable compliance requirements that are subject to varying interpretations;
- i. stating that management has disclosed to the auditor any communications from grantors and pass-through entities concerning possible noncompliance with the applicable compliance requirements, including communications received from the end of the period covered by the compliance audit to the date of the auditor's report;
- j. stating that management has disclosed to the auditor the findings received and related corrective actions taken for previous audits, attestation engagements, and internal or external monitoring that directly relate to the objectives of the compliance audit, including findings received and corrective actions taken from the end of the period covered by the compliance audit to the date of the auditor's report;
- k. stating that management has disclosed to the auditor all known noncompliance with the applicable compliance requirements subsequent to the period covered by the auditor's report or stating that there were no such known instances; and
- l. stating that management is responsible for taking corrective action on audit findings of the compliance audit.

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<sup>3</sup> See section 333, *Management Representations*.

.24 If the auditor determines that it is necessary to obtain additional representations related to the entity's compliance with the applicable compliance requirements, the auditor should request such additional representations.

## Subsequent Events

.25 The auditor should perform audit procedures up to the date of the auditor's report to obtain sufficient appropriate audit evidence that all subsequent events related to the entity's compliance during the period covered by the auditor's report on compliance have been identified. (Ref: par. .A29)

.26 The auditor should take into account the auditor's risk assessment in determining the nature and extent of such audit procedures, which should include, but are not limited to, inquiring of management about and considering

- relevant internal auditors' reports issued during the subsequent period.
- other auditors' reports identifying noncompliance that were issued during the subsequent period.
- reports from grantors and pass-through entities on the entity's noncompliance that were issued during the subsequent period.
- information about the entity's noncompliance obtained through other professional engagements performed for that entity.

.27 The auditor has no obligation to perform any audit procedures related to the entity's compliance during the period subsequent to the period covered by the auditor's report. However, if before the report release date, the auditor becomes aware of noncompliance in the period subsequent to the period covered by the auditor's report that is of such a nature and significance that its disclosure is needed to prevent report users from being misled, the auditor should discuss the matter with management and, if appropriate, those charged with governance, and should include an explanatory paragraph in his or her report describing the nature of the noncompliance. (Ref: par. .A30)

## Evaluating the Sufficiency and Appropriateness of the Audit Evidence and Forming an Opinion (Ref: par. .A31–.A32)

.28 The auditor should evaluate the sufficiency and appropriateness of the audit evidence obtained.<sup>4</sup>

.29 The auditor should form an opinion, at the level specified by the governmental audit requirement, on whether the entity complied in all material respects with the applicable compliance requirements, and report appropriately. In forming an opinion, the auditor should evaluate likely questioned costs, not just known questioned costs, as well as other material noncompliance that, by its nature, may not result in questioned costs.

## Reporting

### Report on Compliance Only

.30 The auditor's report on compliance should include the following elements:

- a. A title that includes the word *independent*

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<sup>4</sup> See paragraphs .70–.76 of section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*.

- b. Identification of the one or more government programs covered by the compliance audit or reference to a separate schedule containing that information
- c. Identification of the applicable compliance requirements or a reference to where they can be found
- d. Identification of the period covered by the report
- e. A statement that compliance with the applicable compliance requirements is the responsibility of the entity's management
- f. A statement that the auditor's responsibility is to express an opinion on the entity's compliance with the applicable compliance requirements based on the compliance audit
- g. A statement that the compliance audit was conducted in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards*, and the governmental audit requirement
- h. A statement that the compliance audit included examining, on a test basis, evidence about the entity's compliance with those requirements and performing such other procedures as the auditor considered necessary in the circumstances
- i. A statement that the auditor believes the compliance audit provides a reasonable basis for his or her opinion
- j. A statement that the compliance audit does not provide a legal determination of the entity's compliance
- k. The auditor's opinion, at the level specified by the governmental audit requirement, on whether the entity complied, in all material respects, with the applicable compliance requirements
- l. If noncompliance that results in an opinion modification is identified, a description of such noncompliance, or a reference to a description of such noncompliance in an accompanying schedule (Ref: par. .A34)
- m. If other noncompliance that is required to be reported by the governmental audit requirement is identified (that is, noncompliance that does not result in an opinion modification), a description of such noncompliance or a reference to a description of such noncompliance in an accompanying schedule (Ref: par. .A34)
- n. If the criteria used to evaluate compliance are
  - i. established or determined by contractual agreement or regulatory provisions that are developed solely for the parties to the agreement or regulatory agency responsible for the provisions or
  - ii. available only to the specified parties,a separate paragraph at the end of the report that includes (1) a statement indicating that the report is intended solely for the information and use of the specified parties (2) an identification of the specified parties to whom use is restricted, and (3) a statement that the report is not intended to be and should not be used by anyone other than the specified parties (Ref: par. .A33)
- o. The manual or printed signature of the auditor's firm
- p. The date of the auditor's report

**Combined Report on Compliance and Internal Control Over Compliance**

.31 If the governmental audit requirement requires the auditor to report on internal control over compliance and the auditor combines the auditor's report on compliance with a report on internal control over compliance, the following should be added to the report elements listed in paragraph .30:

- a. A statement that management is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, rules, and provisions of contracts or grant agreements applicable to government programs.
- b. A statement that in planning and performing the compliance audit, the auditor considered the entity's internal control over compliance with the applicable compliance requirements to determine the auditing procedures for the purpose of expressing an opinion on compliance, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance.
- c. A statement that the auditor is not expressing an opinion on internal control over compliance.
- d. A statement that the auditor's consideration of the entity's internal control over compliance was not designed to identify all deficiencies in internal control that might be significant deficiencies or material weaknesses in internal control over compliance.
- e. The definition of *deficiency in internal control over compliance* and *material weakness in internal control over compliance*.
- f. A description of any identified material weaknesses in internal control over compliance or a reference to an accompanying schedule containing such a description.
- g. If significant deficiencies in internal control over compliance were identified, the definition of *significant deficiency in internal control over compliance* and a description of the deficiencies or a reference to an accompanying schedule containing such a description.
- h. If no material weaknesses in internal control over compliance were identified, a statement to that effect.
- i. The restricted use paragraph described in paragraph .30(n). The restricted use paragraph should be included in all combined reports on the entity's compliance and internal control over compliance.

A combined report on compliance and internal control over compliance is presented in the exhibit of this section.

**Separate Report on Internal Control Over Compliance**

.32 If the governmental audit requirement requires the auditor to report on internal control over compliance and the auditor chooses to issue a separate report on internal control over compliance, the auditor should include in that separate report the elements in paragraph .31(a)–(i) and the following additional elements:

- a. A title that includes the word *independent*
- b. A statement that the auditor audited the entity's compliance with applicable compliance requirements pertaining to [*identify the government program(s) and the period audited*] and a reference to the auditor's report on compliance

- c. A statement that the compliance audit was conducted in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards*, and the governmental audit requirement
- d. The manual or printed signature of the auditor's firm
- e. The date of the auditor's report

**.33** The auditor should report noncompliance as well as other matters that are required to be reported by the governmental audit requirement in the manner specified by the governmental audit requirement. If the other matters required to be reported by the governmental audit requirement are not appropriate for the auditor to report on, the auditor should follow paragraph .38. (Ref: par. .A34)

**.34** The auditor should modify his or her opinion on compliance in accordance with section 508, *Reports on Audited Financial Statements*, if any of the following conditions exist:

- a. The compliance audit identifies noncompliance with the applicable compliance requirements that the auditor believes has a material effect on the entity's compliance.
- b. A restriction on the scope of the compliance audit.

**.35** The auditor should modify the report described in paragraphs .30 and .32 when the auditor makes reference to the report of another auditor as the basis, in part, for the auditor's report.

**.36** In the absence of a governmental audit requirement to report on internal control over compliance, the auditor should, nevertheless, communicate in writing to management and those charged with governance identified significant deficiencies and material weakness in internal control over compliance.<sup>5</sup> (Ref: par. .A35–.A36)

**.37** The auditor also should communicate to those charged with governance of the entity the auditor's responsibilities under GAAS, *Government Auditing Standards*, and the governmental audit requirement, an overview of the planned scope and timing of the compliance audit, and significant findings from the compliance audit.<sup>6</sup>

**.38** Printed forms, schedules, or reports designed or adopted by government agencies with which they are to be filed sometimes contain prescribed wording. If a printed form, schedule, or report requires the auditor to make a statement that he or she has no basis to make, the auditor should accordingly reword the form, schedule, or report or attach an appropriately worded separate report. (Ref: par. .A37)

## Documentation (Ref: par. .A38)

**.39** The auditor should document the risk assessment procedures performed, including those related to gaining an understanding of internal control over compliance.<sup>7</sup>

**.40** The auditor should document his or her responses to the assessed risks of material noncompliance, the procedures performed to test compliance with

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<sup>5</sup> See section 325, *Communicating Internal Control Related Matters Identified in an Audit*.

<sup>6</sup> See section 380, *The Auditor's Communication With Those Charged With Governance*.

<sup>7</sup> See paragraphs .122–.123 of section 314.

the applicable compliance requirements, and the results of those procedures, including any tests of controls over compliance.<sup>8</sup>

.41 The auditor should document materiality levels and the basis on which they were determined.

.42 The auditor should document how he or she complied with the specific governmental audit requirements that are supplementary to GAAS and *Government Auditing Standards*.

### **Reissuance of the Compliance Report (Ref: par. .A39–.A40)**

.43 If an auditor reissues his or her report, the reissued report should include an explanatory paragraph stating that the report is replacing a previously issued report and describing the reasons why the report is being reissued, and any changes from the previously issued report. If additional procedures are performed to obtain sufficient appropriate audit evidence for all of the government programs being reported on, the auditor's report date should be updated to reflect the date the auditor obtained sufficient appropriate audit evidence regarding the events that caused the auditor to perform the new procedures. If, however, additional procedures are performed to obtain sufficient appropriate audit evidence for only some of the government programs being reported on, the auditor should dual date the report with the updated report date reflecting the date the auditor obtained sufficient appropriate audit evidence regarding the government programs affected by the circumstances and referencing the government programs for which additional audit procedures have been performed. Reissuance of an auditor-prepared document required by the governmental audit requirement that is incorporated by reference into the auditor's report is considered to be a reissuance of the report.

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<sup>8</sup> See paragraph .77 of section 318.

## Application Guidance and Explanatory Material

### Introduction and Applicability

**.A1** An example of an engagement to which this section is applicable is an audit performed in accordance with the provisions of Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments and Non-Profit Organizations*. This section is applicable because OMB Circular A-133 is a governmental audit requirement that requires the auditor to perform a compliance audit in accordance with both GAAS and *Government Auditing Standards* and to express an opinion on compliance. Another example is a department specific requirement such as the U.S. Department of Housing and Urban Development *Audit Requirements Related to Entities Such As Public Housing Agencies, Nonprofit and For-Profit Housing Projects, and Certain Lenders*. An example of an engagement to which this section is not applicable is an engagement performed to satisfy a law or regulation requiring the entity to have an auditor determine whether the entity has spent transportation excise tax monies in accordance with the specific purposes outlined in the law or regulation, but not requiring that the audit be performed in accordance with both GAAS and *Government Auditing Standards*. Such an engagement could be performed under AT section 601; AT section 101, *Attest Engagements*; or AT section 201, *Agreed-Upon Procedures Engagements*, depending on the requirements of the government. Law or regulation will not always indicate which standards to follow. In such cases, auditor judgment will be needed to determine, based on the circumstances, the appropriate standards to follow. (Ref: par. .01)

**.A2** An example of a governmental audit requirement that calls for an examination of an entity's compliance with specified requirements in accordance with AT section 601 is the U.S. Department of Education's audit guide *Audits of Federal Student Financial Assistance Programs at Participating Institutions and Institution Servicers*. (Ref: par. .01 and .03)

### Objectives and Definitions

**.A3** Most governmental audit requirements specify that the auditor's opinion on compliance is at the program level. However, some governmental audit requirements may specify a different level (for example, at the applicable compliance requirement level). (Ref: par. .10)

**.A4** Governmental audit requirements also may set forth specific supplementary requirements of the compliance audit (for example, procedures to be performed by the auditor, documentation requirements, the form of reporting, and continuing professional education requirements with which the auditor is required to comply. (Ref: par. .11, definition of *governmental audit requirement*)

### Adapting and Applying the AU Sections to a Compliance Audit (Ref: par. .12)

**.A5** AU sections often identify audit procedures and contain examples that are specific to a financial statement audit. The auditor is not expected to adapt or apply all such procedures to the compliance audit, only those that, in the auditor's professional judgment, are relevant and necessary to meet the objectives of the compliance audit.

## Establishing Materiality Levels (Ref: par. .13)

**.A6** In a compliance audit, the auditor's purpose for establishing materiality levels is to

- a. determine the nature and extent of risk assessment procedures.
- b. identify and assess the risks of material noncompliance.
- c. determine the nature, timing, and extent of further audit procedures.
- d. evaluate whether the entity complied with the applicable compliance requirements.
- e. report findings of noncompliance and other matters required to be reported by the governmental audit requirement.

**.A7** Generally, for all of the purposes identified in paragraph .A6, the auditor's consideration of materiality is in relation to the government program taken as a whole. However, the governmental audit requirement may specify a different level of materiality for one or more of these purposes. For example, for purposes of reporting findings of noncompliance, OMB Circular A-133 requires that noncompliance that is material in relation to one of the 14 types of compliance requirements identified in the OMB *Compliance Supplement (Compliance Supplement)* be reported. (See paragraph .A10 for further information about the *Compliance Supplement*.)

**.A8** Because the governmental audit requirement usually is established by the grantors and the auditor's report on compliance is primarily for their use, the auditor's determination of materiality usually is influenced by the needs of the grantors. However, in a compliance audit, the auditor's judgment about matters that are material to users of the auditor's report also is based on consideration of the needs of users as a group, including grantors.

## Identifying Government Programs and Applicable Compliance Requirements (Ref: par. .14)

**.A9** Some governmental audit requirements specifically identify the applicable compliance requirements. Other governmental audit requirements provide a framework for the auditor to determine the applicable compliance requirements. For example, the *Compliance Supplement* provides such a framework for OMB Circular A-133 audits.

**.A10** The following are some of the sources an auditor may consult when identifying and obtaining an understanding of the applicable compliance requirements:

- a. The *Compliance Supplement*, which is issued by OMB, and used in OMB Circular A-133 audits, contains the compliance requirements that typically are applicable to federal government programs, as well as suggested audit procedures when compliance requirements are applicable and have a direct and material effect on the entity's compliance. Part 7 of the *Compliance Supplement* provides guidance for identifying compliance requirements for programs not included therein.
- b. The applicable program-specific audit guide issued by the grantor agency, which contains the compliance requirements pertaining to the government program and suggested audit procedures to test for compliance with the applicable compliance requirements.

**.A11** The following are procedures the auditor may perform to identify and obtain an understanding of the applicable compliance requirements if the *Compliance Supplement* or a program-specific audit guide is not applicable:

- a. Reading laws, regulations, rules, and provisions of contracts or grant agreements that pertain to the government program
- b. Making inquiries of management and other knowledgeable entity personnel (for example, the chief financial officer, internal auditors, legal counsel, compliance officers, or grant or contract administrators)
- c. Making inquiries of appropriate individuals outside the entity, such as
  - i. the office of the federal, state, or local program official or auditor, or other appropriate audit oversight organizations or regulators, about the laws and regulations applicable to entities within their jurisdiction, including statutes and uniform reporting requirements
  - ii. a third-party specialist, such as an attorney
- d. Reading the minutes of meetings of the governing board of the entity being audited
- e. Reading audit documentation about the applicable compliance requirements prepared during prior years' audits or other engagements
- f. Discussing the applicable compliance requirements with auditors who performed prior years' audits or other engagements

The procedures listed in this paragraph also may assist the auditor in obtaining a further understanding of the applicable compliance requirements even when the *Compliance Supplement* or program-specific audit guide is applicable.

## Performing Risk Assessment Procedures (Ref: par. .15–.16)

**.A12** Obtaining an understanding of the government program, the applicable compliance requirements, and the entity's internal control over compliance establishes a frame of reference within which the auditor plans the compliance audit and exercises professional judgment about assessing risks of material noncompliance and responding to those risks throughout the compliance audit.

**.A13** The nature and extent of the risk assessment procedures the auditor performs may vary from entity to entity and are influenced by factors such as the following:

- The newness and complexity of the applicable compliance requirements
- The auditor's knowledge of the entity's internal control over compliance with the applicable compliance requirements obtained in previous audits or other professional engagements
- The nature of the applicable compliance requirements
- The services provided by the entity and how they are affected by external factors
- The level of oversight by the grantor or pass-through entity
- How management addresses findings

**.A14** Performing risk assessment procedures to obtain an understanding of the entity's internal control over compliance includes an evaluation of the design of controls and whether the controls have been implemented. Internal control consists of the following five interrelated components: the control environment, the entity's risk assessment, information and communication systems, control activities, and monitoring.<sup>9</sup> Paragraphs .14, .67–.101, and appendix B of section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, contain a detailed discussion of these components.

**.A15** The auditor's procedures described in paragraph .16, related to understanding how management has responded to findings and recommendations that could have a material effect on the entity's compliance with the applicable compliance requirements, are performed to assist the auditor in understanding whether management responded appropriately to such findings. Examples of external monitoring include regulatory reviews, program reviews by government agencies or pass-through entities, and grantor reviews. Examples of internal monitoring include reports prepared by the internal audit function and internal quality assessments.

### **Assessing the Risks of Material Noncompliance (Ref: par. .17)**

**.A16** Factors the auditor may consider in assessing the risks of material noncompliance are as follows:

- The complexity of the applicable compliance requirements
- The susceptibility of the applicable compliance requirements to noncompliance
- The length of time the entity has been subject to the applicable compliance requirements
- The auditor's observations about how the entity has complied with the applicable compliance requirements in prior years
- The potential effect on the entity of noncompliance with the applicable compliance requirements
- The degree of judgment involved in adhering to the compliance requirements
- The auditor's assessment of the risks of material misstatement in the financial statement audit

**.A17** In assessing the risks of material noncompliance, the auditor may evaluate inherent risk of noncompliance and control risk of noncompliance individually or in combination.

**.A18** Examples of situations in which there may be a risk of material noncompliance that is pervasive to the entity's noncompliance are as follows:

- An entity that is experiencing financial difficulty and for which there is an increased risk that grant funds will be diverted for unauthorized purposes
- An entity that has a history of poor recordkeeping for its government programs

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<sup>9</sup> See paragraph .41 of section 314.

## Performing Further Audit Procedures in Response to Assessed Risks

**.A19** Paragraphs .04–.06 of section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, provide guidance that may be adapted when developing an overall response to the risks of material noncompliance. (Ref: par. .18)

**.A20** A compliance audit includes designing procedures to detect both intentional and unintentional material noncompliance. The auditor can obtain reasonable, but not absolute, assurance about the entity's compliance because of factors such as the need for judgment, the use of sampling, the inherent limitations of internal control over compliance with applicable compliance requirements, and the fact that much of the evidence available to the auditor is persuasive rather than conclusive in nature. Also, procedures that are effective for detecting noncompliance that is unintentional may be ineffective for detecting noncompliance that is intentional and concealed through collusion between entity personnel and a third party or among management or employees of the entity. Therefore, the subsequent discovery that material noncompliance with applicable compliance requirements exists does not, in and of itself, evidence inadequate planning, performance, or judgment on the part of the auditor. (Ref: par. .19)

**.A21** An auditor may decide to use audit sampling to obtain sufficient appropriate audit evidence in a compliance audit. Section 350, *Audit Sampling*, discusses the factors to be considered in planning, designing, and evaluating audit samples, including sampling for tests of controls. In addition, the AICPA Audit Guide Government Auditing Standards and *Circular A-133 Audits* contains guidance on sampling in the context of a compliance audit. (Ref: par. .19)

**.A22** To test for compliance with applicable laws and regulations, tests of details (including tests of transactions) may be performed in the following areas:

- Grant disbursements or expenditures
- Eligibility files
- Cost allocation plans
- Periodic reports filed with grantor agencies (Ref: par. .19)

**.A23** The use of analytical procedures to gather substantive evidence is generally less effective in a compliance audit than it is in a financial statement audit. However, substantive analytical procedures may contribute some evidence when performed in addition to tests of transactions and other auditing procedures necessary to provide the auditor with sufficient appropriate audit evidence. (Ref: par. .19)

**.A24** Paragraphs .07–.39 and .46–.67 of section 318 provide guidance related to designing and performing further audit procedures in response to the assessed risks of material noncompliance. Paragraphs .40–.45 of section 318, which address the use of audit evidence about the operating effectiveness of controls obtained in prior audits, are not applicable to a compliance audit. (Ref: par. .20)

**.A25** Some governmental audit requirements, for example, OMB Circular A-133, require tests of the operating effectiveness of controls identified as likely to be effective, even if the auditor believes that such testing would be inefficient. (Ref: par. .20)

## Supplementary Audit Requirements

**.A26** Examples of supplementary audit requirements are the requirements in OMB Circular A-133 for the auditor to

- perform specified procedures to identify major programs.
- follow up on prior audit findings and perform procedures to assess the reasonableness of the summary schedule of prior audit findings. (Ref: par. .21)

**.A27** When there is conflicting guidance, the auditor may decide to consult with the government agency responsible for establishing audit guidance or that provides the funding. (Ref: par. .22)

## Written Representations

**.A28** In some cases, management may include qualifying language in the written representations to the effect that representations are made to the best of management's knowledge and belief. However, such qualifying language is not appropriate for the representations in paragraphs .23(a), .23(b), and .23(l). (Ref: par. .23)

## Subsequent Events

**.A29** Two types of subsequent events may occur. The first type consists of events that provide additional evidence with respect to conditions that existed at the end of the reporting period that affect the entity's compliance during the reporting period. The second type consists of events of noncompliance that did not exist at the end of the reporting period but arose subsequent to the reporting period. (Ref: par. .25)

**.A30** An example of a matter of noncompliance that may occur subsequent to the period being audited but before the report release date that may warrant disclosure to prevent report users from being misled is the discovery of noncompliance in the subsequent period of such magnitude that it caused the grantor to stop funding the program. (Ref: par. .27)

## Evaluating the Sufficiency and Appropriateness of the Audit Evidence and Forming an Opinion (Ref: par. .28–.29)

**.A31** In determining whether an entity has materially complied with the applicable compliance requirements, the auditor may consider the following factors:

- a. The frequency of noncompliance with the applicable compliance requirements identified during the compliance audit
- b. The nature of the noncompliance with the applicable compliance requirements identified
- c. The adequacy of the entity's system for monitoring compliance with the applicable compliance requirements and the possible effect of any noncompliance on the entity
- d. Whether any identified noncompliance with the applicable compliance requirements resulted in likely questioned costs that are material to the government program

**.A32** The auditor's evaluation of whether the entity materially complied with applicable compliance requirements includes consideration of noncompliance identified by the auditor, regardless of whether the entity corrected the noncompliance after the auditor brought it to management's attention.

## Reporting

**.A33** Nothing precludes the auditor from restricting the use of any report to intended users.<sup>10</sup> (Ref: par. .30(n))

**.A34** If the report is a matter of public record or available for public inspection, removing personally identifiable information in the compliance audit report and findings of noncompliance will reduce the likelihood of sensitive information being disclosed. (Ref: par. .30(l)–(m) and .33)

**.A35** When the auditor communicates significant deficiencies or material weaknesses in internal control over compliance to management and those charged with governance, *Government Auditing Standards* also requires the auditor to obtain a response from the responsible officials, preferably in writing, concerning their views on the findings, conclusions, and recommendations included in the auditor's report on internal control over compliance and include a copy of any written response in the auditor's report.<sup>11</sup> (Ref: par. .36)

**.A36** If such a written response is included in a document containing the auditor's written communication to management and those charged with governance concerning identified significant deficiencies or material weaknesses in internal control over compliance, the auditor may add a paragraph to his or her written communication disclaiming an opinion on such information. Following is an example of such a paragraph:

ABC Agency's written response to the significant deficiencies [and material weaknesses] in internal control over compliance identified in our compliance audit was not subjected to the auditing procedures applied in the compliance audit of ABC Agency's compliance and, accordingly, we express no opinion on it. (Ref: par. .36)

**.A37** If the auditor is submitting a reworded form, schedule, or report or appropriately worded separate report, the auditor may include a separate communication to the agency explaining why the auditor's report was modified. (Ref: par. .38)

## Documentation (Ref: par. .12 and .39–.42)

**.A38** The auditor is not expected to prepare specific documentation of how the auditor adapted and applied each of the applicable AU sections to the objectives of a compliance audit. The documentation of the audit strategy, audit plan, and work performed cumulatively demonstrate whether the auditor has complied with the requirement in paragraph .12.

## Reissuance of the Compliance Report (Ref: par. .43)

**.A39** The following are examples of situations in which the auditor might reissue the compliance report:

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<sup>10</sup> Footnote 4 of section 532, *Restricting the Use of an Auditor's Report*.

<sup>11</sup> Paragraphs 5.32–.38 of *Government Auditing Standards*.

- A quality control review performed by a governmental agency indicates that the auditor did not test an applicable compliance requirement.
- The discovery subsequent to the date of the compliance report that the entity had another government program that was required to be tested.

**.A40** An example of an auditor-prepared document required by a governmental audit requirement that is incorporated by reference in the auditor's report is the schedule of findings and questioned costs in a compliance audit under OMB Circular A-133.

.A41

## Appendix: AU Sections That Are Not Applicable to Compliance Audits<sup>1</sup>

The following sections are not applicable to a compliance audit performed under section 801 either because (a) they are not relevant to a compliance audit environment, (b) the procedures and guidance would not contribute to meeting the objectives of a compliance audit, or (c) the subject matter is specifically covered in section 801. However, nothing precludes an auditor from applying these sections if the auditor believes they will provide appropriate audit evidence in the specific circumstances to support the auditor's opinion on compliance.

<i>AU Sections That Do Not Apply to Compliance Audits</i>
Paragraph .01 of section 110, <i>Responsibilities and Functions of the Independent Auditor</i>
Standards of reporting in paragraph .02 of section 150, <i>Generally Accepted Auditing Standards</i>
Paragraphs .09, .44–.45, .83–.86, and .102 of section 314, <i>Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement</i>
Paragraphs .12–.13 and .21–.22 of section 315, <i>Communications Between Predecessor and Successor Auditors</i>
Section 317, <i>Illegal Acts by Clients</i>
Paragraphs .40–.45, .52, .68–.69, and the appendix of section 318, <i>Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained</i>
Paragraphs .22–.62 of section 324, <i>Service Organizations</i>
Paragraphs .14–.19 of section 326, <i>Audit Evidence</i>
Section 328, <i>Auditing Fair Value Measurements and Disclosures</i>
Section 330, <i>The Confirmation Process</i>
Section 331, <i>Inventories</i>
Section 332, <i>Auditing Derivative Instruments, Hedging Activities, and Investments in Securities</i>
Paragraph .12 of section 333, <i>Management Representations</i>
Section 334, <i>Related Parties</i>
Section 337, <i>Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments</i>
Section 341, <i>The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern</i>
Section 342, <i>Auditing Accounting Estimates</i>
Section 410, <i>Adherence to Generally Accepted Accounting Principles</i>
Section 420, <i>Consistency of Application of Generally Accepted Accounting Principles</i>
Section 431, <i>Adequacy of Disclosure in Financial Statements</i>
Section 504, <i>Association With Financial Statements</i>

<sup>1</sup> As part of its clarity project, the Auditing Standards Board is revising Statements on Auditing Standards, which will result in conforming changes to the affected references to AU sections in this appendix.

<i>AU Sections That Do Not Apply to Compliance Audits</i>
Paragraphs .05, .08–.09, .11(b)–(h), .14–.18, .27–.28, .33–.34, .38, .41–.57, and .64–.76 of section 508, <i>Reports on Audited Financial Statements</i>
Section 534, <i>Reporting on Financial Statements Prepared for Use in Other Countries</i>
Paragraphs .14 and .16 of section 543, <i>Part of Audit Performed by Other Independent Auditors</i>
Section 544, <i>Lack of Conformity With Generally Accepted Accounting Principles</i>
Section 550, <i>Other Information in Documents Containing Audited Financial Statements</i>
Section 551, <i>Supplementary Information in Relation to the Financial Statements as a Whole</i>
Section 552, <i>Reporting on Condensed Financial Statements and Selected Financial Data</i>
Section 558, <i>Required Supplementary Information</i>
Section 560, <i>Subsequent Events</i>
Section 623, <i>Special Reports</i>
Section 625, <i>Reports on the Application of Accounting Principles</i>
Section 634, <i>Letters for Underwriters and Certain Other Requesting Parties</i>
Section 711, <i>Filings Under Federal Securities Statutes</i>
Section 722, <i>Interim Financial Information</i>
Section 901, <i>Public Warehouses—Controls and Auditing Procedures for Goods Held</i>

[Revised, August 2011, to reflect conforming changes necessary due to the issuance of SSAE No. 16.]

.A42

## **Exhibit: Illustrative Combined Report on Compliance With Applicable Requirements and Internal Control Over Compliance—(Unqualified Opinion on Compliance; No Material Weaknesses or Significant Deficiencies in Internal Control Over Compliance Identified)**

The following is an illustrative combined report on compliance with applicable requirements and internal control over compliance that contains the elements in paragraphs .30–.31. This illustrative report contains an unqualified opinion on compliance with no material weaknesses or significant deficiencies in internal control over compliance identified. The AICPA Audit Guide *Government Auditing Standards and Circular A-133 Audits* contains illustrative language for other types of reports, including reports containing qualified or adverse opinions on compliance with either material weaknesses in internal control over compliance, significant deficiencies in internal control over compliance, or both identified.

### Independent Auditor's Report

[Addressee]

#### **Compliance**

We have audited Example Entity's compliance with the [identify the applicable compliance requirements or refer to the document that describes the applicable compliance requirements] applicable to Example Entity's [identify the government program(s) audited or refer to a separate schedule that identifies the program(s)] for the year ended June 30, 20X1. Compliance with the requirements referred to above is the responsibility of Example Entity's management. Our responsibility is to express an opinion on Example Entity's compliance based on our audit.

We conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*<sup>1</sup> issued by the Comptroller General of the United States; and [insert the name of the governmental audit requirement or program-specific audit guide]. Those standards and [insert the name of the governmental audit requirement or program-specific audit guide] require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the compliance requirements referred to above that could have a material effect on [identify the government program(s) audited or refer to a separate schedule that identifies the program(s)] occurred. An audit includes examining, on a test basis, evidence about Example Entity's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of Example Entity's compliance with those requirements.

In our opinion, Example Entity complied, in all material respects, with the compliance requirements referred to above that are applicable to [identify the government program(s) audited] for the year ended June 30, 20X1.

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<sup>1</sup> The standards applicable to financial audits are in chapters 1–5 of *Government Auditing Standards*.

**Internal Control Over Compliance**

Management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the compliance requirements referred to above. In planning and performing our audit, we considered Example Entity's internal control over compliance to determine the auditing procedures for the purpose of expressing our opinion on compliance, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of Example Entity's internal control over compliance.

A *deficiency in internal control over compliance* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance on a timely basis. A *material weakness* in internal control over compliance is a deficiency, or combination of deficiencies in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a compliance requirement will not be prevented, or detected and corrected, on a timely basis.

Our consideration of internal control over compliance was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be deficiencies, significant deficiencies, or material weaknesses in internal control over compliance. We did not identify any deficiencies in internal control over compliance that we consider to be material weaknesses, as defined above.

This report is intended solely for the information and use of management, [*identify the body or individuals charged with governance*], others within the entity, [*identify the legislative or regulatory body*], and [*identify the grantor agency(ies)*] and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

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