Government Compliance Auditing:
An Analysis of Statement on Auditing Standard No. 68

An Honors Thesis (HONRS 499)

by

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Purpose of Thesis

This analysis of compliance auditing is limited basically to the guidelines provided in Statement of Auditing Standard No. 68, Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance. There is a discussion of the history of compliance auditing, an analysis of the specific requirements of SAS 68, a presentation of the viewpoints of a practicing auditor and an examination of the current developments in this area. This thesis serves to provide an overall understanding of some of the many complex issues that auditors must have knowledge of if they are to successfully perform government compliance audits.

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When the general public hears the word "audit", most people think about an IRS tax audit or possibly about a large corporation audit. However, there is another type of audit that is very important to auditors and to society as a whole. That audit is the government compliance audit. Each and every year thousands of state and local governments and hundreds of federal programs receive billions of dollars in federal financial assistance. Examining the operation of such programs and the spending of this money is the job of not only government auditors, but also of independent CPAs in public practice. Specific guidance for the performance of one of these audits is provided by Statement on Auditing Standards number 68, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance* (referred to as SAS 68). This thesis will present the historical development of compliance auditing as it relates to SAS 68, analyze the specific requirements of SAS 68, offer some commentary from a practicing accountant, and examine current developments related to SAS 68.

**History of Compliance Auditing**

In the mid-1960s, federal financial assistance totaled about 11 billion dollars. Each granting agency had its own requirements for reporting on compliance. In 1968, Congress passed the "Intergovernmental Cooperation Act" to try to help grant recipients better understand requirements. It also simplified the grantee's management of funds and encouraged better coordination of grant planning by providing more information to the states. However, the
act did little to determine auditing procedures of such funds.

During the 1970s, more attention was focused on making the grant recipients more effective and efficient. This translated into a need for more stringent audit requirements to detect and prevent instances of waste, abuse and fraud. Therefore, in 1976, several amendments were added to the "State and Local Fiscal Assistance Act" which provided such audit requirements of recipient governments. Also in 1976, the first office of Inspector General for Health and Human Services was created by Congress to identify areas of waste and abuse. Then in 1977, a Presidential directive was issued to eliminate duplication and waste in the management of programs receiving federal financial assistance. This prompted the creation of other Inspector Generals to oversee major federal programs.

February 1979 saw the creation of the Joint Financial Management Improvement Program (JFMIP). It was comprised of representatives from the offices of the Comptroller General of the United States and the Director of the office of Personnel Management. The JFMIP performed a study that reported several major problems with federal agencies including varying audit approaches, multiple audit guidelines and contradictory reporting requirements. It also found that there was some audit duplication, lack of audit coverage, lack of audit coordination and reliance by federal agencies on audits conducted by other federal agencies.

The General Accounting Office (GAO) also conducted a study of audit methods used in auditing federal funds in 1979. This study
looked at the audit experience of 73 grant recipients for fiscal years ending 1974 through 1977. These grantees received some $240 billion total during this time period of which nearly $192 billion was never audited. The number of times a recipient was audited ranged from zero to more than fifty. Compounding the problem was the fact that the recipients could undergo concurrent audits conducted by public accountants as well as by federal, state and local auditors. Due to lack of coordination between these groups of auditors, the same accounting records and internal controls were reviewed and the same personnel were questioned by the different auditors.

Therefore, it was determined that the grant-by-grant basis of auditing contributed to the duplication, overlap, gaps in coverage and lack of coordination that the government wanted to eliminate. Both the JFMIP and the GAO recommended the adoption of a single audit approach for all recipients of federal financial assistance. Congressional hearings ensued to discuss the identified problems. As a result, the Office of Management and Budget (OMB) issued Circular A-102, attachment P, Audit Requirements. It required that a single audit of recipients be conducted on an organization-wide basis.

In 1980, the OMB published a Compliance Supplement to outline the major compliance provisions of circular A-102P. The OMB also assigned a cognizant agency to each of the fifty states and large local governments to oversee all phases of the single audit. In 1981, the JFMIP issued "Cognizant Agency Guidelines" to establish
uniform guidelines and communications between recipient organizations and cognizant agencies. However, despite these efforts, the implementation of circular A-102P was slow. In 1982, a committee was formed for the purpose of demonstrating the need for legislation to force acceptance of the single audit. They conducted a study to review and evaluate the current status of the single audit. The final report of the committee issued in May 1984 identified the following impediments to the implementation of the single audit:

1. agencies were slow in adopting A-102P into policy
2. cognizant agency designation was slow
3. questions arose concerning which grant funds would pay for the single audit
4. inconsistent audit requirements remained in grantor regulations

The OMB was also working on revising Attachment P, but the revision was never actually released.

By 1984, the federal financial assistance to state and local governments had increased to nearly 100 billion dollars and Congress became concerned about the efficiency and effectiveness of grant audits. About the same time the OMB and the Committee were studying the progress of A-102P, bills were introduced in both the House of Representatives and the Senate regarding single audits. The "Single Audit Act of 1984" was passed in October 1984. Its main objectives are: to improve governmental financial management of federal financial assistance programs; to establish uniform requirements for audits of federal financial assistance programs;
to promote efficiency and effectiveness in the use of audit resources; and to ensure that federal agencies depend on the single audit to the maximum extent possible.

The Single Audit Act of 1984 made the Director of the OMB responsible for prescribing policies, procedures and guidelines for the implementation of the legislation. Each federal granting agency must also make amendments to its audit regulations to conform with the audit requirements of the law. In April 1985, the OMB issued circular A-128, the final regulations for state and local governments to be in compliance with the Single Audit Act. The regulations specify which audit reports are to be prepared, answer questions that arise for those undergoing a single audit and allow for sanctions to be imposed on governments that do not follow the provisions of the law. At the same time, the OMB also issued a revised "Compliance Supplement for Single Audits of State and Local Governments". Part one presents some general requirements while part two has specific requirements applicable to the 62 federal programs that provide over 90 percent of the financial assistance to state and local governments.

In 1988, the GAO also made several revisions of its standards, the "yellow book". The most significant areas of change included: expanded continuing professional education requirements; new internal and external quality control standards; audit risk and materiality criteria; responsibility for audit follow-up; supplemental fieldwork and reporting standards having to do with the Single Audit Act; and guidance on the procurement of audit
services. In April 1989, the AICPA issued SAS 63 which established the guidance for compliance auditing applicable to state and local governments. It addressed responsibilities involved with three types of engagements: audits in accordance with generally accepted auditing standards (GAAS); audits in accordance with generally accepted governmental auditing standards (GAGAS) or "yellow book"; and single audits in accordance with OMB Circular A-128. However, in March 1990, the OMB issued Circular A-133, Audits of Institutions of Higher Education and Other Nonprofit Institutions. The standards needed to incorporate the ideas of this new publication, therefore, SAS 68 was issued in December 1991. It was a revision of SAS 63 and served to supersede it. The two standards are basically the same except that SAS 68 also provides guidance on compliance auditing responsibilities in single audits in accordance with OMB Circular A-133 and certain other guidelines for the auditor to follow if he becomes aware that the client may need a more in-depth audit.

There have been many different approaches over the years as many different auditors performed compliance audits. However, these differences have somewhat been eliminated by the Single Audit Act of 1984. What the AICPA has successfully done is to consolidate into SAS 68 the interpretations of audit guidelines for compliance audits under GAAS, GAGAS, and the Single Audit Act. The following section will analyze the specific requirements of SAS 68.

Specific Requirements of SAS 68

Statement on Auditing Standard number 68 encompasses a wide
array of requirements that relate to compliance auditing. Specifically, it offers direction for audits performed in accordance with one or more of the following: GAAS; GAGAS or the "yellow book"; The Single Audit Act of 1984 and OMB Circular A-128; OMB Circular A-133; or other compliance audit requirements, such as state and local laws or program-specific audits. One can think of the requirements of SAS 68 as being arranged pyramidically. Guidelines related to audits in accordance with GAAS would be at the top; direction related to audits in accordance with GAGAS would be in the middle; and guidance in accordance with the Single Audit Act of 1984 would be at the base (See Exhibit 1).

**Compliance Audits in Accordance with GAAS**

Compliance audits in accordance with GAAS consist of audits of the financial statements of (1) governmental entities or (2) other entities receiving federal financial assistance. The auditor's responsibility regarding laws and regulations and their effects on the financial statements are the same in this type of compliance audit as they are in any other financial statement audit. These areas are discussed in SAS 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, and SAS 54, *Illegal Acts by Clients*. SAS 53 requires the auditor to assess the risk that errors and irregularities may cause a material misstatement on the financial statements. It also states that the audit should be planned to provide reasonable assurance of detecting such material errors and irregularities. SAS 54 explains the auditor's responsibility to be to detect and report any misstatements
Reports Required by GAAS, GAGAS, and Single Audit

"Regular" Audit vs. GAO Standards vs. Single Audit

GAGAS and "Yellow Book" (GAO Standards)  
3 (Possibly 4) Reports

Report on Financial Statements

Report on Entity's Internal Control Structure  
Report on Entity's Compliance with Laws and Regulations

GAAS "Regular Audit"  
1 Report

Single Audits -- OMB Circulars A-128 & A-133  
8 (Possibly 9) Reports

Report on FFA Statement  
Report on Internal Controls Over FFA  
Report on FFA General Compliance  
Report on FFA "Major" Compliance  
Report on FFA "Non-Major" Compliance

Report on Fraud, Abuse or Illegal Acts

* Report includes an auditor's opinion.
resulting from illegal acts that have a direct and material effect on the determination of financial statement amounts.

SAS 68 discusses some planning considerations in the area of laws and regulations and how they might affect the financial statements. For example, an entity that receives federal financial assistance (FFA) may be subject to laws and regulations regarding: specific goods and services that may be purchased with such financial assistance; what individuals or groups are eligible to benefit from this financial assistance; specific levels of effort, matching or earmarking of funds that is required; and allowable costs and cost principles which may be used in determining costs of FFA programs. Also, SAS 68 offers some procedures that help the auditor in assessing management's identification of applicable laws and regulations and in obtaining an understanding of their effects on the financial statements. They are as follows:

(1) Consider knowledge about such laws and regulations obtained from prior years' audits.

(2) Discuss such laws and regulations with the entity's chief financial officer, legal counsel or grant administrators.

(3) Review the relevant portions of any directly related agreements.

(4) Review the minutes of meetings of the legislative body of the governmental entity under audit for enactment of laws and regulations with direct and material effect on the financial statements.

(5) Inquire of the federal, state or local auditor about applicable laws and regulations including statutes and uniform reporting requirements.

(6) Inquire of the program administrators of the governmental entities that provided the grants about restrictions, limitations, terms and conditions under
which they were provided.

(7) Review compliance requirement information from state CPA societies or government associations.

After obtaining an understanding of the impact of laws and regulations, the auditor should assess the risk that a material misstatement will occur from the violation of such laws. The nature, cause and amount of prior misstatements as well as the competence of personnel should be considered. An auditor is also responsible for assessing control risk related to an engagement. Factors influencing control risk related to a compliance audit are (1) management's level of awareness of applicable laws and regulations, (2) entity policy regarding acceptable operating practices and codes of conduct and (3) assignment of responsibility and delegation of authority to deal with organizational goals and objectives, operating functions and regulatory requirements.

Besides planning guidance, SAS 68 also gives direction in the areas of working-paper documentation and written representations from management. Basically, the paragraph regarding working papers reminds the auditor to follow SAS 41, Working Papers. They state that the working papers should include documentation that:

(1) The work has been adequately planned and supervised, indicating the observance of the first standard of field work.

(2) A sufficient understanding of the internal control structure has been obtained to plan the audit and determine the nature, timing and extent of testing.

(3) The audit evidence obtained, the auditing procedures applied and the testing performed have provided a sufficient competent evidential matter to afford a reasonable basis for an opinion, indicating observance of the third standard of field work.
The paragraph related to management representations suggests obtaining two additional statements. These would acknowledge that management is responsible for the entity's compliance with applicable laws and regulations and that management had identified and disclosed to the auditor all laws and regulations that have a direct and material effect on the determination of financial statement amounts. They would be submitted along with the letter from management that acknowledges, among other things, management's responsibility for the financial statements as a whole.

Compliance Audits in Accordance with GAGAS or "Yellow Book"

In an audit performed in accordance with GAGAS, the auditor assumes responsibilities beyond those assumed in an audit in accordance with GAAS. These responsibilities relate to reporting on compliance with laws and regulations and on the internal control structure. Guidance provided by the "yellow book" relates to financial audits and to performance audits. However, the requirements of SAS 68 refer to the "yellow book" standards as they apply only to financial audits.

The first added responsibility that the auditor assumes in a compliance audit in accordance with GAGAS is the preparation of a written report of compliance with laws and regulations. This report should contain statements of positive or negative assurance for compliance, instances of noncompliance and indications of illegal acts that could result in criminal prosecution. The basis for this report are the procedures performed by the auditor as part of the financial audit. Paragraph 6 on page 5-2 of Government
Auditing Standards includes the standard that "a test should be made of compliance with applicable laws and regulations". SAS 68 states that an auditor shall have complied with this standard if he designs the audit to provide reasonable assurance of detecting errors, irregularities and illegal acts that have a direct and material effect on the financial statements.

Since designing the audit to test all areas for compliance with laws and regulations would be too costly, only certain items are tested. Positive assurance is given on items tested. Negative assurance is given when procedures do not bring anything to the auditor's attention that would indicate noncompliance for items not tested. A report on compliance with laws and regulations should contain the following basic statements:

(1) The financial statements have been audited and a reference to the auditor's report on these statements.

(2) The audit was conducted in accordance with GAAS and GAGAS.

(3) GAAS and GAGAS require the auditor to obtain reasonable assurance about whether the financial statements are free of material misstatements.

(4) Management is responsible for compliance with laws, regulations, contracts and grants.

(5) The auditor performed tests of compliance with certain provisions of laws, regulations, contracts and grants.

(6) The objective of the audit was not to provide an opinion on overall compliance with such objectives and a disclaimer of such an opinion.

(7) Positive assurance by the auditor that for items tested the entity was materially in compliance.

(8) Negative assurance for items not tested that nothing came to the auditor's attention that would indicate
material noncompliance.

(9) Certain immaterial instances of noncompliance were reported to management in a separate letter.

(10) The report is intended for the information of management, the audit committee and specific legislative or regulatory bodies, but not to limit distribution if it is a matter of public record.

(11) The signature of the auditor's firm and the date of the report.

The above outlined statements are considered the standard report for communicating compliance with laws and regulations. However, the statements of positive and negative assurance should be modified when material instances of noncompliance are discovered during the audit. This modified or qualified report should include a definition of the material instances of noncompliance, specific identification of such instances to put them in proper perspective, and a statement that the noncompliance was considered in forming the opinion on the financial statements.

The second added responsibility under GAGAS is the requirement that the auditor report on cases of illegal acts that may result in criminal prosecution. However, the auditor ordinarily does not possess the expertise to know which acts may result in criminal prosecution. Therefore, GAGAS states that the auditor should promptly report illegal acts to the top official of the entity arranging for the audit, to the audit committee or, in certain instances, to the appropriate oversight body. GAGAS also advises that the auditor should not release information or reports containing information regarding such illegal acts without first consulting legal counsel. This serves to protect the auditor from
possible legal action and also makes good sense.

In an audit in accordance with GAAS the auditor is required to communicate only "reportable conditions" noted during the audit. This communication can be done either in oral or written form. The auditor is also permitted, but not required to identify any reportable conditions he considers "material weaknesses". SAS 60 defines a reportable condition as a deficiency in design or operation of the internal control structure, which could adversely affect the organization's ability to record, process, summarize and report financial data in consistency with management's assertions. A material weakness is a reportable condition of such magnitude that there remains a higher risk that material errors or irregularities will not be detected by employees and, therefore, will flow through to the financial statements.

In contrast to SAS 60, the third added responsibility in a compliance audit performed in accordance with GAGAS is that the auditor report on the internal control structure. SAS 68 provides that this communication should inform management of the following: (1) any reportable conditions noted; (2) a description of such reportable conditions; (3) identification of those that are considered to be material weaknesses; (4) identification of the categories of the internal control structure; (5) a description of the scope of the auditor's work in obtaining an understanding of the internal control structure and assessing control risk; and (6) a description of deficiencies in the internal control structure not considered significant enough to be reportable conditions. If
"nonreportable conditions" are not communicated in the required reports, a separate letter to top management should be issued that discloses such instances.

The required internal control report in a financial statement audit conducted in accordance with GAGAS should contain the following statements:

(1) The financial statements have been audited and a reference to the auditor's report on these statements.

(2) The audit was conducted in accordance with GAAS and GAGAS.

(3) In planning and performing the audit, the auditor considered the internal control structure for purposes of expressing an opinion on the financial statements and not to provide assurance on the internal control structure.

(4) Establishment and maintenance of internal control structure are responsibilities of management.

(5) Explanation of broad objectives and inherent limitations of any internal control structure.

(6) Description of the entity's significant internal control structure policies and procedures considered as part of auditor's understanding of the structure.

(7) Description of the scope of the auditor's work.

(8) Definition of reportable conditions.

(9) Description of reportable conditions noted.

(10) Definition of material weaknesses.

(11) Identification of which, if any, reportable conditions were considered material weaknesses.

(12) Other matters relating to internal control structure and operation were communicated to management in another letter.

(13) The report is intended for the information of management, the audit committee and specific legislative or regulatory bodies, but not to limit distribution if it is a matter of public record.
The above statements satisfy GAGAS when reportable conditions are noted. If no reportable conditions are noted, SAS 60 prohibits the auditor from issuing a report to indicate such. However, GAGAS requires a written internal control report on all engagements. To settle the difference, SAS 68 also provides an example of a report that satisfies both requirements when no reportable conditions are noted.

**Compliance Audits in Accordance with the Single Audit Act**

An auditor assumes the greatest amount of responsibility when performing an audit in accordance with the Single Audit Act of 1984 and OMB Circular A-128 which was issued to help implement the act. State and local governments are required to have an audit in accordance with the Single Audit Act if they receive total federal financial assistance (FFA) in excess of $100,000 in a fiscal year. For a state or local government that receives between $25,000 and $100,000 in FFA, they have the option of having a single audit under the act or having an audit in accordance with the regulations governing the programs in which the state participates. State and local governments that receive less than $25,000 in FFA are not required to have an audit performed. In addition to the reports required under GAGAS, the auditor must issue the following reports for an audit performed in accordance with the Single Audit Act: a schedule of all FFA received and expended; a report on the internal control systems in place to manage FFA; a report on compliance with general requirements applicable to FFA; a report on compliance with
specific requirements having material effect on major programs; and a report on compliance with certain laws and regulations applicable to nonmajor programs.

OMB Circular A-128 identifies nine general requirements that relate to "significant national policy" and therefore must be followed by all recipients of federal financial assistance. The auditor is to use his professional judgment to establish the extent of testing required and to evaluate the engagement to see if each general requirement represents an area that has direct and material effect on the financial statements. The general requirements deal with the following issues:

(1) Use of federal funds for political activity is prohibited.

(2) Laborers working on federally financed construction projects shall earn prevailing regional wages established by the Secretary of Labor under the Davis-Bacon Act.

(3) Violation of anyone's civil rights in a federally funded program is prohibited.

(4) Recipients of FFA shall minimize the time lapsed between receipt and disbursement of that assistance.

(5) Relocation assistance shall be provided and real property acquisition is designated.

(6) Certain federal financial reports are to be filed.

(7) Certain direct and indirect costs are allowable for federal reimbursement.

(8) Grantees must certify that they provide a drug-free workplace.

(9) Certain Common Rule administrative requirements should be followed.

The standards do not require the auditor to issue a statement of opinion. However, a report expressing positive and negative
assurance on compliance with the general requirements is issued. An example of a "standard" report on compliance with general requirements is shown in paragraph .52 of SAS 68.

The Single Audit Act of 1984 also requires the auditor to determine and report on the entity's compliance with "laws and regulations that have a direct and material effect on each major federal financial assistance program". OMB Circular A-128 identifies the specific requirements applicable to major programs. It states that the auditor should test for compliance with these requirements as a basis for forming an opinion on compliance. The specific requirements generally pertain to: what types of goods and services the entity may purchase with FFA; what characteristics individuals or groups receiving FFA must possess; what matching, level of effort, or earmarking of funds must be contributed from the entity's own resources; what specific reports must be filed in addition to general requirements; and special tests and provisions for which federal agencies have determined that noncompliance could materially affect the program.

To help the auditor meet the requirements of the Single Audit Act and OMB Circular A-128, SAS 68 gives guidance in the following matters relating to auditing and reporting on specific requirements:

(1) Identification of major FFA programs;

(2) Materiality in a compliance audit of major FFA programs;

(3) Components of audit risk in a compliance audit;

(4) Specific requirements applicable to major FFA
programs;
(5) Subrecipient considerations;
(6) Management representations; and
(7) Evaluating results of audit procedures.

Program Identification. The schedule of federal financial assistance is useful in determining what are major and nonmajor programs. It is to include all federal funds received and expended whether they come directly from federal agencies or from state and local levels. It is also to contain a list of the programs under which the funds were received. A major program is defined as any program for which expenditures exceed a specified amount relative to the total expended on all programs. The Act provides explicit guidance, but generally speaking, a major program is one with expenditures of at least $300,000.

Materiality. An auditor’s consideration of materiality in a compliance audit of major FFA programs is different than that of an audit of financial statements. The auditor must make an adjustment for what is considered to be material to each major program. The nature and amount of any noncompliance must be considered in relation to the nature and amount of the specific program under audit. An amount that is material to one program may be immaterial to another, and an amount that is material to a program in one year may be immaterial to the same program the next year.

Audit Risk. Audit risk is the risk that an auditor unknowingly fails to appropriately modify his opinion on compliance. It consists of inherent risk, control risk and detection risk.
Inherent risk is the risk that material noncompliance with requirements applicable to major FFA programs could occur, assuming no related internal control policies or procedures. SAS 68 suggests considering such things as the newness of the program and its amount of receipts and expenditures, among other things, when assessing inherent risk. Control risk is the risk that material noncompliance in a major FFA program would not be prevented or detected on a timely basis by the internal control structure. The auditor is required to understand the internal control structure so that he would be able to identify types of potential noncompliance, consider matters that affect the risk of material noncompliance and design effective tests of compliance with requirements of major FFA programs. Detection risk is the risk that the auditor’s procedures will lead him to conclude no material noncompliance exists when in fact it does. An acceptable level of detection risk is accepted on the basis of the assessed levels of inherent and control risk. The nature, extent and timing of the tests are adjusted accordingly.

Subrecipient Considerations. If a subrecipient receives $25,000 or more of FFA from a primary recipient in any one fiscal year, then the primary recipient is responsible for determining that the subrecipient expends the funds in accordance with applicable laws and regulations. The primary recipient’s auditor is required to evaluate its system for monitoring the subrecipient. The auditor may be engaged to audit the subrecipient, but the Single Audit Act does not require this as part of the audit of the primary recipient.
Management Representations. SAS 68 requires that an auditor, engaged to perform an audit of specific requirements of major FFA programs, obtain written representations from management. Specific representations that should be obtained in the letter are statements that among other things:

(1) Management has identified all sources of FFA in the schedule of federal financial assistance.

(2) Management has identified the general requirements.

(3) Management has identified applicable specific requirements identified in the schedule of FFA.

(4) Management has complied with reporting requirements in connection with FFA.

(5) Information presented in federal financial reports and claims for reimbursements is supported by the books and records from which the basic financial statements have been prepared.

(6) Management monitored the action of subrecipients, has taken corrective action on a timely basis after receipt of subrecipient’s auditor’s report, and made any necessary adjustments to the entity’s own books and records.

(7) Management has identified and disclosed to the auditor all amounts questioned and known noncompliance with requirements that could have a material effect on a major FFA program.

If management refuses such a written representation, the auditor faces a scope limitation that may be sufficient to require a qualified opinion or a disclaimer of opinion. Furthermore, the auditor should consider the effects of management’s refusal on his ability to rely on other management representations.

Evaluation of Audit Procedures. In evaluating whether the entity has complied with laws and regulations that have a material effect on each major program, the auditor should examine the effects of
identified instances of noncompliance. SAS 68 states that the auditor should consider the frequency of noncompliance identified in the audit, the adequacy of the primary recipient's system for monitoring subrecipients and the effect on the program of any identified noncompliance by a subrecipient, and if any instances of noncompliance resulted in questioned costs that may be material to the program. A questioned cost is identified as an unallowable cost, undocumented cost, unapproved cost or unreasonable cost established by Congress or other granting agencies. Regardless of the auditor's compliance opinion, he must report on all instances of noncompliance and any resulting in questioned costs.

**Responsibilities Under OMB Circular A-133**

OMB Circular A-133 prescribes audit requirements for institutions of higher education and other nonprofit institutions receiving federal awards. Nonprofit institutions that receive $100,000 or more per year in federal awards are subject to A-133. Nonprofit entities that receive $100,000 or more under only one program have the option of an audit performed in accordance with A-133 or an audit of only the one program. Those nonprofit institutions that receive between $25,000 and $100,000 in federal awards have the option of being audited under Circular A-133 or having each federal award audited. Nonprofit institutions receiving less than $25,000 are not subject to federal audit requirements.

The reports required by OMB Circular A-133 are similar to the ones required by the Single Audit Act and OMB Circular A-128.
Therefore, the other sections of SAS 68 are applicable to higher education and nonprofit audits. OMB Circular A-133 requires tests and reports on the following:

1. Compliance with laws and regulations that may have a direct and material effect on the financial statements.

2. Compliance with general requirements applicable to federal award programs.

3. Compliance with specific requirements that may have a direct and material effect on each major program.

4. Compliance with certain laws and regulations applicable to nonmajor federal award programs.

The definition of a major program in OMB Circular A-133 is a program with expenditures total to the larger of 3% of total federal funds expended or $100,000. Each of the following categories of federal awards constitute a major program: research and development; student financial aid; and other individual awards.

**Other Compliance Auditing Responsibilities**

SAS 68 also offers guidance on the performance of certain program-specific audits. In such instances, auditors should obtain an understanding of specific audit requirements through publications of the grantor agency or through direct contact with the agency. Similarly, an auditor might be engaged to perform an audit of compliance with state and local laws. In this case, the auditor should obtain an understanding of audit guidelines through discussions with the organization's management, inquiry of the state or local auditor, or review of information from state societies of CPAs.
As is evidence by the vast amount of information compiled in SAS 68, there are many requirements and guidelines that an auditor must be aware of and follow if he is to perform a successful compliance audit. What follows are some thoughts and opinions regarding such requirements from a practicing auditor with experience in compliance auditing.

**Practical Commentary**

Denny Faurote is an Audit Manager in the Indianapolis office of the Big Six accounting firm of Deloitte & Touche. During his career, he has been assigned to several compliance engagements throughout the state of Indiana. The following comments and views are from a discussion held with Mr. Faurote about the impact compliance auditing has on a public accounting practice. Some of the topics covered were: the challenges involved with a compliance audit; some of the criteria his office considers when pursuing a compliance engagement; liability issues that must be considered; and an overall view of a compliance audit practice.

One of the things that Denny identified as a challenge is the fact that a lot of times the clients are unaware of all the laws, regulations and reporting requirements to which their organization is subject. In such instances, the auditor (Deloitte & Touche) must try to reconstruct where funds came from originally to determine which regulations apply. Then the funds must be traced as they flow through the organization to test compliance. The auditor, therefore, becomes more involved with the preparation of the financial statements. As a result, his independence as an
auditor may be affected and the engagement could be lost to another firm. A second challenge, is simply trying to comply with all the requirements and guidelines of compliance auditing. Specifically, making sure the audit is adequately designed to ensure compliance and sufficiently documenting tests and procedures related to internal controls present difficulties. An example related to planning the audit is checking to see if the entity is in compliance with Equal Employment Opportunity Commission acts. This involves obtaining an attorney's letter regarding any discrimination litigation. If there is such a lawsuit pending, the auditor must determine the materiality of the probable outcome for purposes of disclosure. Also, any such cases should be included in the management letter.

A second topic that Denny commented on was the criteria his firm used in deciding whether or not to pursue a compliance audit client. One of the first things looked at is the timing of the majority of the field work. Since most not-for-profit compliance audits are not big money-makers for the firm, partners prefer the work be completed in off peak months. For most firms this is the time period of about May through September. A second issue considered are the reporting requirements of the organization. This is important because the firm does not really want to have to assign a lot of staff to complete a low profit engagement. A third important factor is the entity's level of understanding of the applicable laws and regulations as they relate to operations and accounting. The higher the level of understanding, the better the
basis for getting started with the audit. A final consideration would be the effect that this engagement would have on the firm's public image. For example, a firm may be more willing to accept a low profit compliance audit of a large, well-known agency based on its ability to enhance public image. Just desiring to obtain a certain compliance audit client, however, isn't enough. After a firm bids on an engagement, the state auditors, major granting agency or other oversight division must approve them. They do this on the basis that the auditors meet the continuing professional education requirements of the Government Accounting Standards and that the firm undergoes a peer review every three years. Denny mentioned that this is somewhat of an advantage for a Big Six firm seeking to obtain compliance engagements because they rarely have difficulty obtaining approval from the oversight agencies.

The third topic that Denny discussed was the liability issues related to compliance audits. He said that he felt they were inherently riskier than a regular financial audit in accordance with GAAS simply due to the fact that there was so much regulation in the area. He also considered them to be riskier because of the possible results of a compliance audit that finds an organization in violation of laws and regulations. Since an entity may be required to pay back some funding, assessed a penalty or lose their future funding altogether as a result of not complying with applicable laws and regulations, the auditor must be absolutely positive of their findings. Also, since these reports are going to government agencies that are very concerned with
compliance, the audit must be designed to detect all material instances of noncompliance. The auditors definitely must know what they are getting into with a compliance audit because failure can have repercussions from not only the client, but also the government.

Finally, Denny offered his opinion on the overall picture of a firm with compliance audit practice. He noted that not every firm can devote the time and resources necessary to make the audits run smoothly. Compliance auditing is an area that requires a large amount of resources for a small amount of revenue in return. For this reason, a lot of smaller firms do not undertake many compliance audit clients. Larger firms may be better suited to allow staff to work in this field and become more specialized. However, even though Denny works with compliance audits, he admits that he must go back to the standards to refresh himself every once in awhile. Another plus that comes with compliance audits is that the incremental dollar amounts provided in the off season also help to flatten out the revenue cycle somewhat. To summarize, Denny said that he felt the purpose of the Single Audit Act of 1984 and the compliance audit standards that followed were needed, but that in a practical sense they were very difficult to work through.

Current Developments

As mentioned previously, the General Accounting Office has made several changes to Government Auditing Standards or the "yellow book". These new standards focus on improving quality control in compliance audits. To upgrade the professional
proficiency required by GAAS general standards, continuing professional education (CPE) requirements have been further developed. Specifically, auditors responsible for planning, directing or conducting a substantial portion of a government audit must complete 24 hours of CPE every two years related directly to government auditing. The GAO has also considered that this requirement be met before beginning field work. The "yellow book" has added a fourth general standard which states that a firm that conducts governmental audits must have sufficient internal controls in place and be subject to external quality control review every three years.

More recently, the GAO has proposed changes to the "yellow book" in the areas of examining the entity's internal control. The exposure draft proposes expanding the auditor's responsibilities related to management controls. The exposure draft classifies management controls into four categories: controls over program operations to ensure it meets its objectives; controls over validity and reliability of data; controls over compliance with laws and regulations; and controls over safeguarding assets. The auditor would be responsible to specifically assess whether the control environment enhances or undermines the effectiveness of control procedures. Also, the auditor would be required to identify potentially vulnerable assets, look for the effect of possible misstatement of the financial statements and determine what controls are in place to safeguard such assets. By doing this, the auditor gains a better understanding of the entity and
can do a better job of planning and performing the audit. The effect of these proposed changes would mean more work for the auditors and possibly higher fees for the clients. However, greater audit coverage would mean more useful information about the safeguarding and use of taxpayers' money.

**Conclusion**

What I have tried to present is an overview of the many issues and complexities involved with a government compliance audit. Over the years, the public has called for increased accountability by government and those who receive government funding. The Single Audit Act of 1984 did an excellent job responding to this challenge. What SAS 68 does is expand the auditors responsibilities to help them implement the various audit requirements. While a government compliance audit may pose a significant challenge for auditors, its completion should be rewarding because not everyone can perform one successfully.

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1 Information in this section comes from two articles: (1) Brown and Burnaby and (2) Broadus, Jr. and Comtois.

2 Information in this section comes from SAS 68 the two articles by Fitzsimons and Levine.

3 Information in this section comes from the articles by Williams, Koebele and Langowski, and McNameee.
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AICPA Codification of Statements on Auditing Standards, Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance, AU Section 801, paragraphs .01-.99.


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