POSITION PAPER ON THE QUALITY REVIEW OF SIX SINGLE AUDITS

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Introduction and Background

The Department of Labor (DOL), Office of Inspector General (OIG), is evaluating single audits performed in accordance with OMB Circular A-133 and the Single Audit Act Amendments of 1996. The purpose of the evaluation is to determine if single audits provide sufficient evidence to support the OIG's opinion on the Department's financial statements. As part of the evaluation, we performed certain procedures for six single audits conducted for entities receiving DOL awards.

Objectives

The specific objectives of this evaluation were to determine whether: (1) the single audits performed for six sites selected meet the requirements of OMB Circular A-133 and the Single Audit Act Amendments of 1996, and (2) sufficient audit work is performed in single audits pertaining to various DOL programs selected for major program testing in accordance with OMB Circular A-133.

Scope and Methodology

This project was performed following the procedures outlined in the *Uniform Quality Control Review Guide for A-133 Audits, 1999 Edition*, issued by the President's Council on Integrity and Efficiency. These procedures were performed for six entities that were recipients of DOL funding and filed single audit reports for fiscal years ending in 2000 or 1999. These entities included two states, two state subrecipients, and two private nonprofit organizations. Under the guidance and assistance of DOL OIG personnel, a site visit was scheduled with each of these entities and review teams were established for each one of the entities selected. The teams consisted of R. Navarro & Associates, Inc., and DOL OIG personnel.

OMB Circular A-133 has various requirements for conducting the single audit. We reviewed the work performed by the auditors of the single audit to determine whether they performed adequate audit procedures in accordance with the OMB Circular A-133 requirements. This position paper primarily focuses on the following two requirements:

1. Section 500(c) requires that the auditor plan and test internal controls over major programs to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program.

2. Section 500(d)(4) requires the auditor to test transactions and such other auditing procedures necessary to provide the auditor sufficient evidence to support an opinion on compliance. Section 6.36 of the AICPA's Statement of Position No. 98-3 (SOP 98-3) requires that compliance testing include tests of transactions and such other auditing procedures as are necessary to provide the auditor with sufficient evidence to support an opinion on compliance for each major program.

Summary of Conclusions

Based on our review of the six sites, we believe that the single audit procedures performed at these entities were not adequate. Over 60 percent of the applicable compliance requirements were either not tested for internal controls, or were not adequately tested for the level of assurance required by OMB Circular A-133. In addition, the auditors did not perform additional procedures to gather sufficient evidence to support the opinion on compliance. In fact, when some of the auditors found errors indicating a high risk system and a high probability of material noncompliance, the auditors did not modify their audit approach. We found that small sample sizes were not increased (or additional work was not performed) in cases where internal controls did not ensure a low level of risk. In some cases, auditors gathered no audit evidence at all, and did not document why compliance testing was not performed.

Tests performed by the single audit auditors identified material noncompliance (in one case a best estimate of the noncompliance amounted to $64 million) yet the internal control finding (material weakness) did not provide sufficient information to the auditee or the funding source to enable them to know the extent of the problem. The sample identified a high percentage of errors which, in our opinion, the auditor should have projected the attribute errors to the universe. This noncompliance exceeded the auditors materiality by 500 percent, yet the auditor issued a qualified opinion. We believe that the audit evidence gather in this instance did not support the compliance opinion issued by the auditor.

Part of the objective of the reviews was to determine if the Department of Labor's funds, if audited properly under the Single Audit, received audit coverage. We believe that while DOL programs were sufficiently selected for major program testing, the funds were not adequately audited due to the other issues noted in this position paper.

Internal Controls Testing

Introduction

OMB Circular A-133 and the Statement of Position No. 98-3 requires the auditors of single audit engagements to evaluate and test the recipient's internal control policies and procedures over compliance with Federal laws and regulations as they apply to major Federal assistance programs.

Summary of Single Audit Requirements for Internal Controls

OMB Circular A-133 and SOP 98-3 require the auditors to test the recipient's internal controls for a low level of control risk. A low level of risk allows the auditor to place a high reliance on the system of internal controls and should be used by the auditor to determine the nature, timing and extent of other compliance procedures necessary to gather sufficient evidence to support the auditor's opinion on compliance requirements.

The OMB Compliance Supplement, Part 6, is intended to assist non-Federal entities and their auditors in complying with these requirements by describing for each type of compliance requirement the objectives of internal control, and certain characteristics of internal control that, when present and operating effectively, may ensure compliance with program requirements. The Compliance Supplement lists examples of internal controls for 13 of the 14 compliance requirements. Because the fourteenth compliance requirement (special tests and provisions) is unique to each program, it does not have internal control characteristics listed.

Summary of Sampling Requirements for an Assessment of Internal Controls for a Low Level of Risk.

As stated above, OMB Circular A-133 and the SOP 98-3 require the auditor to plan and test internal controls over compliance for major programs to support a low assessed level of control risk. The AICPA in the Audit and Accounting Guide ***Audit Sampling*** (page 32)**,** states that if the auditor wishes to place a high reliance on the internal controls, the auditor should use lower tolerable rates, such as a tolerable rate of 2 percent to 7 percent. The ***Practitioner's Guide to Audit Sampling,*** by Dan M. Guy, Douglas R. Carmichael, and O. Ray Whittington, published in 1998, states that if the auditor plans to assess control risk at a low level, and he or she desires a large degree of evidence from the sample (i.e., no other tests will be performed), a tolerable rate of 5 percent or less might be considered appropriate. The publication also shows that for a low level of control risk, the auditor should still perform other tests of compliance. A low assessment of control risk does not relieve the auditor from gathering additional evidence to support the opinion on compliance. Generally Accepted Auditing Standards **(AU 312.25)** indicate that complete reliance should not be placed on the assessment of inherent and control risk (i.e., tests of controls) to the exclusion of performing substantive tests of account balances. The internal control phase is conducted in order for the auditor, based on the control risk, to determine the nature and timing of other procedures to gather additional evidence required to support the opinion.

The sample sizes using a 90 percent confidence level, a tolerable rate of 7 percent and expected error rates between 0 and 3 percent would be in the range of 32 to 94 transactions. However, the majority of the single audits reviewed had sample sizes of less than 32 transactions.

Testing of Internal Controls

In determining the sample size for internal control testing, the auditors for all six of the sites either assumed that the universe contained no errors (which would result in a low sample size) or judgmentally determined what the sample size would be (normally 25 or less sample items). The majority of the audits did not properly document the sampling methodology. In addition, we noted that all of the sites had applicable compliance requirements that were either not tested for internal controls or were not adequately tested.

In reaching our conclusions, we considered the work performed by the single auditors for each compliance criteria where the auditor would be required to test internal controls. There are 14 potential compliance criteria for each major program. We assessed the work performed for each of the 14 criteria at each of the 6 sites, for a total of 84 criteria assessments. Of these 84 criteria, 28 were not applicable to the major program(s) reviewed. The remaining 56 compliance requirements were subject to internal control testing. The results for these criteria are summarized as follows:

	Compliance Requirements	Percentage
Internal Controls were adequately tested	19	34%
Internal Controls were not adequately tested	24	43%
Internal Control testing was not performed	13	23%
Total	**56**	**100%**

Internal Controls Were Not Adequately Tested

The above shows that for 24 compliance requirements, or 43 percent of the compliance requirements applicable to the six sites visited, internal controls were not properly tested using a low assessed level of control risk. Based on this information, the auditors cannot place high reliance on the system of internal controls and would be required to gather more evidence to support their opinion on compliance requirements for each major program. However, the majority of the auditors did not perform any other procedures to support their opinion on compliance (to be discussed later). The lack of adequate testing of internal controls was caused by the following:

1. **Inadequate Sample Sizes**. The sample sizes were not adequate to test internal controls for a low assessed level of control risk. In determining the sample size for internal control testing, the auditors either assumed that the universe contained no errors (which resulted in very low sample sizes) or judgmentally determined the sample size. One site used moderate rather than low risk for establishing sample sizes.

   The AICPA in the Audit and Accounting Guide ***Audit Sampling*** recommends that, for an auditor to make an assessment of internal controls for a low level of control risk, they should

use a tolerable rate between 2 percent to 7 percent. The minimum sample size at a 7 percent tolerable rate is 32 items (using a confidence level of 90 percent and assuming that the universe contains zero errors). However, if we believe that the universe contains a 2 percent error rate, the minimum sample size increases to 75 items. We noted that all of the audits had at least one internal control test using inadequate sample sizes (samples commonly ranged from 11 to 25 items). For example, we noted that the compliance requirements for Equipment and Real Property Management, and Procurement, Suspension and Debarment at two sites were tested with less than 10 transactions. At another site, program income was tested with less than 20 transactions.

One auditor tested matching requirements at only one of numerous locations, and then concluded for the entire universe of transactions. This is referred to as block sampling, and according to the AICPA's ***Audit Sampling***, page 29, a sample with only a few blocks tested is generally not considered adequate to support a conclusion. In addition, the sample was small, only 25 transactions, and was not sufficient to support a low assessed level of control risk.

At two sites, we noted samples where certain compliance attributes were not tested for many of the items selected. In such cases, the auditors should replace the items to ensure that the number of items actually tested is adequate. For example, one site had a large universe of placements into unsubsidized employment. The auditor selected a sample of 25 payroll transactions and added an attribute to verify placement into unsubsidized employment. The workpaper showed that for 23 of the 25 transactions, the attribute was "not applicable." Therefore, the actual number of items tested for the placement attribute was two transactions. This is not sufficient to assess internal controls at any level.

2. **Tests Performed Not Sufficiently Documented**. Four of the six auditors did not comply with workpaper requirements in that the sampling plan was not documented. The sampling plan whether statistical or non-statistical is required to be documented in accordance with both AICPA **(AU 339.05)** and Government Audit Standards **(Section 4.46 and 4.37)**. We also noted in two audits that the workpapers did not contain sufficient information in support of the items selected for testing, such as the check number, the classification of the transactions, the payee, the amount of the payment or the fact that the goods were received.

3. **Test Results Not Sufficiently Evaluated**. Four of the six auditors did not sufficiently evaluate the results of their testing, and none made adjustments to their audit approach based on the test results. One test identified an error rate of more than 20 percent, which indicated a high risk system, yet the auditor did not change the audit approach or extrapolate the errors to the universe.

4. **Tests Not Properly Designed.** We noted that three of the audits excluded certain costs from the universe tested for allowability of costs. One auditor excluded administrative costs for rent, indirect costs, supplies, travel and other costs from the universe when performing dual purpose tests for this compliance requirement. This auditor also did not include 100 percent of the costs of a major program in the universe tested. The auditee had several grants

with the same CFDA codes (17.246 and 17.250), yet only certain grants were included in the universe for major program testing.

5. **Incomplete Testing Procedures**. Two sites had sufficient sample sizes; however, the attributes used for the testing were not complete. The OMB Compliance Supplement, Part 6, is intended to assist non-Federal entities and their auditors in complying with the requirements of OMB Circular A-133 and SOP 98-3, by describing for each type of compliance requirement the objectives of internal control, and certain characteristics of internal control that when present and operating effectively may ensure compliance with program requirements. The procedures used by the auditors to test internal controls were not complete to make the proper assessment of operating effectiveness of the internal controls. For example, one of these auditors used a generic audit program that was not applicable to the major program tested. As a result, the auditor did not test all of the necessary areas of internal controls.

Internal Control Testing Was Not Performed

We found that in three of the six audits reviewed, one or more compliance criteria were not tested for internal controls. There was a combined total of 56 compliance criteria that were applicable for internal control testing. The auditors did not test internal controls for 13 of the 56 (23 percent) applicable compliance requirements, nor did the auditors document why testing was not performed. The following is the compliance testing that did not receive adequate coverage:

a. Eligibility internal controls were not tested at three of the sites.
b. Equipment and Real Property Management internal controls were not tested at two sites.
c. Matching, level of effort, or earmarking internal controls were not tested at three sites.
d. Period of Availability of Federal funds internal controls were not tested at three sites.
e. Procurement, Suspension and Debarment's internal controls were not tested at two sites.

In the majority of the cases, the auditors stated that the criteria were not applicable, even though the Compliance Supplement stated that the criteria generally applied to the major programs. The auditor did not document why the requirements were not applicable. We believe that the criteria were applicable and required the auditor to document why no audit work was performed in these areas.

With respect to eligibility, our reviews of one state and two of its subrecipients lead us to conclude that JTPA eligibility was not tested at any level within the state. The state believed that the auditors of the subrecipients were testing eligibility, and the subrecipients believed that the state auditors were testing eligibility. As a result of this confusion, no evidence was gathered for compliance with eligibility requirements.

Conclusion on Assessment of Internal Controls

Based on our review of the six sites, we believe that the single audit procedures performed at these entities were not adequate. Over 60 percent of the applicable compliance requirements were either not tested for internal controls, or were not adequately tested for the level of assurance required by OMB Circular A-133. With the small samples and the lack of testing of internal controls for some

of the compliance requirements, the auditors did not obtain reasonable assurance of detecting material noncompliance nor should the auditors place a high reliance on the system of internal controls in determining the nature, timing and extent of the other tests of details.

Compliance Testing

Introduction

OMB Circular A-133 and the AICPA's Statement of Position No. 98-3 (SOP 98-3) require the auditors of single audit engagements to determine the nature, timing and extent of compliance tests for each major program based on the outcome of the evaluation and tests of the recipient's internal control policies and procedures over compliance with Federal laws and regulations.

Summary of Single Audit Requirements for Compliance Testing

OMB Circular A-133 and SOP 98-3 require that the auditors of single audit engagements render an opinion on compliance with laws and regulations as they pertain to each major program.

SOP 98-3, Section 6.36, states that compliance testing includes tests of transactions and such other auditing procedures as are necessary to provide the auditor with sufficient evidence to support an opinion on compliance with each major program.

SOP 98-3, Section 6.37, states that in determining the nature, timing and extent of tests to perform, the auditor's professional judgment regarding the appropriate level of detection risk should be used. In applying this judgment, the auditor should be aware that small sample sizes for tests of details with a low dollar value and from a large population generally do not, by themselves, provide sufficient evidence.

SOP 98-3, Section 6.39, states that the auditor should apply procedures to provide reasonable assurance of detecting material noncompliance. Section 6.41 states that the auditor's objective is to accumulate sufficient evidence to limit audit risk to a level that is, in the auditor's judgment, appropriately low for the high level of assurance being provided.

Compliance Testing

In our internal control discussion, we concluded that for 66 percent of the applicable compliance requirements, internal controls were either not tested or not tested for a low assessed level of control risk. We also found that the auditors performed no other procedures for tests of details other than the internal control tests, which we assume was intended to be a dual-purpose test of internal controls and tests of details. For the majority of the criteria, we conclude that the auditors did not gather sufficient evidence to support the opinion on compliance.

Sufficiency of Audit Evidence	Applicable Compliance Requirements	Percentage
Compliance Testing gathered sufficient evidence	20	36%
Compliance Testing did not gather sufficient evidence	36	64%
Total	**56**	**100%**

Compliance Testing Did Not Gather Sufficient Evidence

The data show that for 64 percent of the applicable compliance criteria, auditors did not gather sufficient evidence to support the opinion on compliance. All six of the sites reviewed had applicable compliance requirements for which sufficient audit evidence was not obtained. At one site, the auditor did not gather sufficient evidence for any of the applicable requirements.

The reasons for not gathering sufficient evidence can be attributed to the following:

1. **Insufficient Sample Sizes**. As stated in our discussion on internal controls, the sample sizes used by the auditors, for the most part, were too small. We also conclude that sample sizes used in these audits resulted in excessively high audit risk and were not sufficient to support the auditors' opinions on compliance. SOP 98-3 states that the audit procedures should provide reasonable assurance of detecting material noncompliance. It also requires auditors to accumulate sufficient evidence in support of the opinion on compliance, thereby limiting audit risk to an appropriately low level. When auditors limit their audit evidence to small sample sizes, they limit the chance of detecting material noncompliance and increase audit risk.

   A statistical table developed by Dr. James Lackritz, Chairman of the IDS Department, College of Business Administration, San Diego State University, is presented in Exhibit III. This table shows the probability of finding at least one error with different sample sizes. If an auditor uses a sample of 25, the auditor has a 64 percent chance of detecting at least one error and a 26 percent chance of detecting at least two errors. With a sample of 60, the auditor has a 92 percent chance of detecting at least one error and a 70 percent chance of detecting at least two errors. A 64 percent chance of detecting one error equates to audit risk in excess of 30 percent, whereas audit risk is normally set at a range of 5 to 10 percent (SAS No. 39 illustrates audit risk at 5 percent). Audit risk of 30 percent does not provide reasonable assurance of detecting material noncompliance.

   One auditor selected a sample of 37 transactions (the universe of transactions was not documented) with a book value of 36 percent of the total funding (slightly over $2 million). The auditor used a method based on materiality and risk factor to calculate the sample size, but made an error in the calculation resulting in a very small sample size (37 items). The correct calculation provided a sample size of about 60 items. The statistical table referred to above shows that a sample size of 37 transactions provides a 76 to 80 percent chance of detecting at least one error. The audit risk associated with this small sample is slightly over 20 percent, which is considered excessive. Using the correct sample size of 60 transactions, audit risk is 8 percent, which is within the parameters established in audit guidance.

   One auditor tested allowability of costs by testing 20 random transactions with a book value of 3 percent of the universe. The sample was not stratified and did not include significant items. The sample of 20 items resulted in only a 56 percent chance of detecting one error and only a 19 percent chance of detecting 2 errors. The audit risk for this test is 44 percent, and no other audit procedures were performed. We conclude that the audit work performed did not provide reasonable assurance of detecting material noncompliance.

Another auditor tested cash management using a sample of 5 transactions out of a total of 100 receipts of Federal funds. This is not a sufficient sample to support the opinion. For the matching requirement, the auditor tested 25 transactions that were selected from one site out of approximately 45 sites. Not only was the sample size of 25 not sufficient, but the sample was not random to the total number of sites. With a sample of 25, the auditor had a 64 percent chance of finding one error and a 26 percent chance of finding two errors. The audit risk associated with this sample is 36 percent, which is quite high.

2. **Audit Samples Not Stratified**. The audit samples utilized were not stratified nor did the auditors first test significant transactions followed by a sample of the remainder. Generally Accepted Auditing Standards (**AU 326)** state that the auditor should take into account significant items which will be audited 100 percent and the remaining population will be sampled. Also, these standards state that the auditor should identify any transactions or accounts that are individually important because of size, as well as those transactions or accounts that he or she believes have a high likelihood of misstatement. Only one site was found to have identified significant items for compliance testing, and we noted errors in some of the resulting calculations.

   For example, one auditor tested allowable costs using a sample of 40 random transactions and 10 haphazardly selected transactions. The book value of the sample amounted to $77,000, or only .80 percent of the total book value of approximately $100 million. The reason for the low dollar coverage was due to the fact that the auditor did not identify or test individually significant items. While a sample of 50 items may have been sufficient to make an assessment for internal control purposes, the fact that the auditor tested only $77,000 in book value from a very large universe, indicates that the auditor did not gather sufficient evidence to support the opinion on allowability of costs. Small sample sizes for tests of details with a low dollar value and from a large population generally do not by themselves, provide sufficient audit evidence.

3. **Tests of Compliance Limited to Dual-Purpose Samples**. In all six sites, the auditors did not perform additional test of details beyond those performed for internal control testing. Therefore, the tests performed were considered dual-purpose tests, since the auditor tested the same transactions for internal control and substantive purposes. All of the samples were unrestricted and comprised of mostly low dollar value transactions. SOP 98-3 states that in applying judgment, the auditor should be aware that small sample sizes for tests of details with a low dollar value and from a large population generally do not, by themselves, provide sufficient audit evidence. The sample sizes commonly ranged from 11 to 25 items.

   The ***Practitioner's Guide to Audit Sampling*** indicates that if the auditor plans to assess control risk at a low level, and he or she desires a large degree of evidence from the sample (i.e., no other tests will be performed), the tolerable rate for the sample would be 5 percent or lower.

The sample sizes using a 4 percent and a 5 percent tolerable rate, with a 90 confidence level would be as follows (***Audit Sampling,*** page 107):

Expected Rate of Errors	Sample Size 4% Tolerable Rate	Sample Size 5 % Tolerable Rate
Zero expected deviations (errors)	57	45
1 percent expected deviations (errors)	96	77
1.5 percent expected deviations (errors)	132	105
2 percent expected deviations (errors)	198	132

These sample sizes are much higher than the actual samples used by the auditors.

Eligibility, when tested was audited using a dual-purpose test. One site tested eligibility with a sample of 20 transactions. As stated previously, when the auditor desires a low level of control risk and performs no other tests of details, the sample should be determined using a tolerable rate around 5 percent. At this level, the minimum sample size would be 45 items. The auditor's sample of 20 items only had a 56 percent chance of finding one error (instance of noncompliance) and a 19 percent chance of finding two errors. The audit risk associated with a sample of 20 is above 40 percent, which is extremely high. We believe that this dual-purpose test did not provide the auditor with sufficient audit evidence to support the opinion on compliance with eligibility requirements.

4. **Inadequate Scope of Work.** In addition to the limited samples, we noted instances where the auditors simply did not perform any audit tests for required areas of compliance. One auditor did not gather sufficient evidence for any of the required compliance criteria. At this site the auditor sampled a total of 52 transactions, which were only tested for allowable costs and allowable activities. There was no evidence gathered by the auditor for any of the other applicable compliance requirements. The sample selected for allowable costs was not stratified and excluded certain items from the universe (administrative costs such as rent, office supplies, travel, indirect costs and other costs were excluded from the universe). Also, the workpapers supporting this test did not show sufficient descriptive information (required by ***Government Auditing Standards***) such as the payment amount, the check number, the account charged and whether the goods or services had been received. This auditor did not gather any evidence for eligibility because he believed that the State would audit eligibility for the state as a whole. However, the auditee contracted with the intake agency and it was their responsibility to audit eligibility.

   Another auditor did not test three applicable compliance requirements, tested the period of availability requirement using the wrong period of time, and tested subrecipient monitoring by reviewing seven requests for payment (the universe was not documented).

   As mentioned in our discussion on internal controls, our reviews of one state and two of its subrecipients lead us to conclude that JTPA eligibility was not tested at any level within the state. The state believed that the auditors of the subrecipients were auditing eligibility and

the subrecipients believed that the state auditors were testing eligibility. As a result of this confusion, no evidence was gathered for eligibility requirements.

5. **Inappropriate Reliance on Internal Auditor.** We found that one audit placed inappropriate reliance on the work performed by internal auditors. This site was required to place the enrollees into unsubsidized employment. The internal auditors selected 18 sites for testing this requirement. The single auditor visited two of these sites and reperformed every third item tested by the monitors, for a total of seven transactions. The single auditor did not have evidence in their workpapers as to the results of the work performed by the internal auditors at the 18 sites. We do not believe that the audit work performed was sufficient evidence to support the audit opinion. Generally Accepted Auditing Standards **(AU 322.18 and 322.19)** state that the work of internal auditors cannot alone reduce audit risk to an acceptable level to eliminate the necessity to perform tests of those assertions by the auditor. The auditor's reperformance of seven transactions is not considered sufficient to reduce audit risk to an acceptable level.

6. **Audit Results Not Sufficiently Evaluated.** As noted in the internal control discussion, we found that four of the six auditors did not sufficiently evaluate the results of their internal control testing, and none made adjustments to their audit approach based on the test results. We also found that the sample results were not sufficiently evaluated for substantive purposes.

   One auditor tested a total of 36 transactions with a book value of approximately $118,000 (.10 percent) out of a total funding of $110 million. The auditor found questioned costs of approximately $3,000. The error rate noted by the auditor was 14 percent, which indicates a high risk system. However, the auditor did not adjust the test of details to gather additional evidence to support the opinion.

   The same auditor tested UI eligibility using a sample of 79 transactions, and identified 19 benefit payments computed in error. While this indicates a high risk system, the auditor did not gather any additional evidence to quantify the potential errors in the universe or to support the compliance opinion. In prior years, the auditor had identified this system as high risk, yet the sample size was not adequate for a system with a high expected rate of errors. The errors extrapolated by the auditor exceeded the materiality level by approximately 500 percent. The auditor properly questioned the costs associated with the 19 errors, which amounted to $3,001 and rendered a qualified opinion on compliance. We believe that the audit evidence gathered in this instance did not support the compliance opinion issued by the auditor.

Conclusion on Compliance Testing

Based on our review of the six sites, we believe that the tests of compliance performed at these entities were not adequate. The auditors did not gather sufficient evidence to support the opinion on compliance for 64 percent of the applicable compliance criteria. All six of the sites reviewed had applicable compliance requirements for which sufficient audit evidence was not obtained. The auditors limited their tests to small dual-purpose samples, and did not perform any additional audit

procedures even when the system was found to be high risk. The auditors stopped testing whether they had a low risk or high risk system.

EXHIBIT I

SUMMARY OF REQUIREMENTS OF OMB CIRCULAR A-133
AUDITS OF STATE, LOCAL GOVERNMENTS AND NON-PROFIT ORGANIZATIONS
ISSUED JUNE 24, 1997

The Single Audit Act Amendments of 1996 (Public Law 104-156) is the Federal statute that establishes a legal requirement for governmental entities and nonprofit organizations expending stipulated amounts of Federal awards to have an audit in compliance with specifications in the Act and related regulations.

OMB Circular A-133 ***Audits of State, Local Governments and Non-Profit Organizations,*** provides detailed guidance for implementing the Act's broad provisions. The Act gave the OMB authority to prescribe policies, procedures, and guidelines to implement the Act.

The following is a summary of selected significant requirements of OMB Circular A-133.

1. Section 500(a) requires that the audit of the entity shall cover the entire operations of the auditee. This section of the Circular states that:

> The audit shall cover the entire operations of the auditee; or, at the option of the auditee, such audit shall include a series of audits that cover departments, agencies, and other organizational units, which expended or otherwise administered Federal awards during such fiscal year, provided that each such audit shall encompass the financial statements and schedule of Federal expenditures of Federal awards for each such department, agency, and other organizational unit, which shall be considered to be a non-Federal entity.

2. The audit threshold includes all organizations that expend $300,000 or more in a year in Federal awards. Section 200(a) provides that governmental entities and nonprofit organizations that expend $300,000 or more in a year in Federal awards must either have a single or program-specific audit performed for the year in accordance with Circular A-133 and the Single Audit Act Amendments of 1996. Section 200(d) provides that governmental entities and nonprofit organizations that expend less than $300,000 in a year in Federal awards are exempt from Federal requirements.

3. Section 220 requires that audits be performed annually for the operations of the entity's fiscal year. Biannual audits are allowed in limited circumstances; however, the biannual audits must cover both years within the biennial period.

4. Section 105 requires that the audit focus on programs, not separate awards, when determining major programs or assessing whether a program-specific audit may be elected. Federal programs are defined as:

a. All Federal awards to a non-Federal entity assigned a single Catalog of Federal Domestic Assistance (CFDA) number.

b. When no CFDA number is assigned, all Federal awards from the same agency made for the same purpose should be combined and considered one program.

c. Awards defined as a cluster program. Cluster program means a grouping of closely related programs that share common compliance requirements.

5. Sections 400(a) and (b) list the responsibilities of the cognizant and oversight agencies. A cognizant agency is assigned for recipients spending more than $25 million a year in Federal awards. For those agencies spending less than $25 million a year, the Federal awarding agency that provides the predominant amount of direct funding to a recipient becomes the entity's oversight agency.

6. Section 520 of the Circular prescribes a risk-based approach to determining which Federal programs are major programs. The risk-based approach shifts the audit away from traditional major programs with the largest dollar amount of funding to an emphasis on programs that show signs of managerial weakness or that by their nature are inherently risky.

7. Section 520(h) lists a four-step process for determining major programs.

8. Section 520(f) requires that the auditor shall audit as major programs Federal programs with Federal awards expended that, in the aggregate, encompass at least 50 percent of total Federal awards expended. If the entity has been determined to be a low-risk entity, as described in Section 530, the auditor need only audit as major programs Federal programs with Federal awards expended that, in the aggregate, encompasses at least 25 percent of total Federal awards.

9. Section 500(c) requires that the auditor shall plan the testing of internal control over major programs to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program. The auditor shall perform testing of internal control as planned in accordance with Section 500(c)(2)(i).

10. Section 500(d) requires the auditor to determine whether the auditee has complied with laws, regulations, and the provisions of the contract or grant agreements that may have a direct and material affect on each of its major programs. The OMB Compliance Supplement identifies 14 compliance requirements. The 14 compliance requirements which may apply, if they have a direct and material affect on a major program are:

Activities Allowed
Allowable Cost
Cash Management
Davis-Bacon Act
Eligibility

Equipment and Real Property Management
Matching, Level of Effort, Earmarking
Period of Availability of Federal Funds
Procurement and Suspension and Debarment
Program Income
Real Property Acquisition and Relocation Assistance
Reporting
Subrecipient Monitoring
Special Tests and Provisions

11. Section 520(d)(4) requires the auditor to test transactions and such other auditing procedures necessary to provide the auditor sufficient evidence to support an opinion on compliance.

12. Section 505 covers audit reporting. The following are required:

    a. Opinion on the financial statements based on an audit.
    b. Reporting on internal control. The report shall disclose the scope of testing of internal controls and whether the tests performed provided sufficient evidence to support an opinion on internal controls.
    c. Reporting on compliance with laws and regulations that may have a direct and material effect on the financial statements, disclosing fraud, illegal acts, and other material noncompliance.
    d. Reporting on the supplementary schedule of expenditures of Federal awards. The schedule presents total Federal awards expended for each program.
    e. Reporting on internal control over major programs.
    f. An opinion as to whether the auditee complied with laws and regulations, and the provisions of contracts or grant agreements which have a direct and material affect on each major program.
    g. Schedule of findings and questioned costs.

EXHIBIT II

SUMMARY OF REQUIREMENTS OF AICPA STATEMENT OF POSITION 98-3 (SOP 98-3) *AUDITS OF STATE, LOCAL GOVERNMENTS AND NON-PROFIT ORGANIZATIONS RECEIVING FEDERAL AWARDS*

SOP 98-3 provides guidance on the auditor's responsibilities when conducting a single audit or program-specific audit in accordance with the Single Audit Act Amendments of 1996 and OMB Circular A-133. This AICPA requirement provides guidance on testing and reporting on compliance with laws and regulations in engagements performed under Generally Accepted Auditing Standards (GAAS), the Yellow Book, and OMB Circular A-133.

The SOP provides the auditors of governmental entities and not-for-profit organizations with a basic understanding of the work they should do and the reports that they should issue under the Yellow Book and OMB Circular A-133.

The SOP also provides guidance about financial and compliance auditing standards and requirements related to single audits. Applicable standards and requirements are promulgated by the OMB, GAO and AICPA. This SOP provides guidance on applicable auditing standards and requirements established by those organizations to assist the auditors in planning, performing, and reporting on single audits and program-specific audits in accordance with those standards and requirements, and includes illustrative audit reports. Since Circular A-133 is the Federal policy guidance to which auditors are held in performing single audits, this SOP primarily focuses on A-133 requirements.

The following is a summary of the pertinent requirements to performing single audits:

1. Section 1.24 states that the scope of the auditor's work in an audit in accordance with OMB Circular A-133 is determined by (a) the level of assessed risk associated with the Federal programs and whether they are identified as major programs and (b) the compliance requirements applicable to those programs.

2. Section 1.25 states that the audit scope depends on whether the Federal awards expended are identified as relating to major programs. Circular A-133 places the responsibility for determining major programs on the auditor and provides criteria in applying a risk-based approach for making this determination.

3. Section 1.26 states that the auditor will determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material affect on each of its major programs.

4. Section 1.27 states that the compliance requirements are outlined in the OMB Compliance Supplement. Section 1.28 states that the auditor should follow the guidance contained in the Compliance Supplement.

5. Chapter 2 of the SOP outlines the general audit requirements such as Audit Threshold, Applicable Standards and Covered Entity, Frequency of the Audits, Audit Objectives, Audit Reports, and Other Administrative Requirements. These items are covered in OMB Circular A-133.

6. Section 6.10 requires the auditor to plan the testing of internal controls over compliance for major programs to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program.

7. Section 6.11 outlines the requirements of SAS No. 82, which provides guidance to the auditor on his or her responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to fraud. Because SAS No. 82 only applies to audits of financial statements, its requirements do not apply to an audit of compliance with specified requirements applicable to major programs. However, as part of assessing audit risk in a single audit, the auditor should specifically assess the risk of material noncompliance with a major program's compliance requirements occurring due to fraud.

8. Section 6.14 states that in designing audit tests and developing an opinion on the auditee's compliance with compliance requirements, the auditor should apply the concept of materiality to each major program taken as a whole, rather than to all major programs combined.

9. Section 6.35 requires the auditor to obtain an understanding of relevant portions of internal controls over compliance sufficient to plan the audit and to assess control risk for compliance with specified requirements. The auditor is required to obtain an understanding of internal control and to perform testing of internal controls for a low assessed level of control risk for major programs.

10. Section 6.36 requires that compliance testing include tests of transactions and such other auditing procedures as are necessary to provide the auditor with sufficient evidence to support an opinion on compliance for each major program. Such compliance testing may be performed concurrently with tests of internal controls, as substantive testing or as a combination of the two.

11. Section 6.37 states that in determining the nature, timing and extent of tests to perform, the auditor's professional judgment regarding the appropriate level of detection risk should be used. In applying this judgment, the auditor should be aware that small sample sizes for tests of details with a low dollar value and from a large population generally do not, by themselves, provide sufficient evidence.

    In determining the nature, timing, and extent of the testing of compliance, the auditor should consider audit risk and materiality related to each major program.

12. Section 6.39 says that the auditor should apply procedures to provide reasonable assurance of detecting material noncompliance.

13. Section 6.41 states that the auditor's objective is to accumulate sufficient evidence to limit audit risk to a level that is, in the auditor's judgment, appropriately low for the high level of assurance being provided.

14. Section 6.43 requires the auditor to consider the OMB Compliance Supplement for the objectives for each type of compliance requirement that the auditor should consider in planning and performing tests of compliance requirements.

15. Section 6.44 states that the Compliance Supplement contains suggested audit procedures for testing Federal programs for compliance. The auditor is neither required to follow the procedures nor restricted to using only the procedures outlined in the Compliance Supplement. The auditor is to use professional judgement on the procedures the auditor will perform to obtain sufficient evidence to form an opinion on the compliance requirements that could have a direct and material affect on each major program.

16. Section 6.45 allows the auditor to obtain evidential matter with either non-statistical or statistical sampling. SAS No. 39, ***Audit Sampling*** discusses both types of sampling. SAS No. 74, ***Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Government Financial Assistance,*** and Circular A-133 require the auditors to calculate both the known questioned costs and the likely (projected) questioned costs associated with audit findings.

17. Section 6.47 states that auditors must obtain sufficient evidence to support an opinion on compliance for each major program. Separate samples for each major program are not required; however, experience has shown that it is preferable to select separate samples from each major program, because the separate samples provide clear evidence of the tests performed. If the auditor selects samples from the universe of major programs, the auditor is required to document whether the evidence gathered is sufficient to support an opinion on each major programs's compliance.

18. Section 6.59 requires the auditor to consider both the known questioned costs and the best estimate of the total costs questioned (likely questioned costs). When the likely questioned costs exceed $10,000, the auditor is required to report the known questioned costs.

EXHIBIT III

SAMPLING

OMB Circular A-133 requires that internal controls be tested if the auditor's understanding of internal controls indicates that controls are likely to be effective (Sections 500(c)(2)(i) and 500(c)(3)) in the prevention or detection of material non-compliance. The Circular requires the auditor to plan the test work to support a low control risk assessment. SOP 98-3 provides several areas of guidance relating to samples and sample sizes. The following are a few of the key requirements:

1. SOP 98-3 (Section 3.42) states that if the auditee's system administers more than one major program using common internal controls, the transactions of those programs could be combined into one population for selecting sample sizes. For efficiency purposes, testing only one common system is preferable to testing several different systems.

   The SOP continues that when testing transactions from major programs, the auditor could use the same sample to test internal control over financial reporting, internal control over compliance, and compliance requirements (Section 3.42). The SOP in essence encourages the use of a "dual-purpose" testing approach in which one sample can be used, when appropriate, for several different types of testing.

2. SOP 98-3 does not set forth a required sample size for compliance testing. It does point out that the final decision on how much and what to test remains with the auditor. However, it does list certain items of guidance that should be considered by the auditor:

   a. Section 6.6 requires the auditor to limit audit risk to an appropriate low level. Audit risk and materiality, among other matters, need to be considered together in determining the nature, timing, and extent of auditing procedures and in evaluating the results of those procedures.

   b. Section 6.12 refers to Circular A-133 which states that compliance testing must include tests of transactions and such other auditing procedures necessary to provide the auditor with sufficient evidence to support an opinion on compliance. Such compliance testing serves to limit detection risk (the risk that the auditor's procedures will lead him or her to conclude that noncompliance that could be material to a major program does not exist when, in fact, such noncompliance does exists (Section 6.7)). The auditor is, therefore, required to reduce detection risk to an acceptable level.

   c. Sections 6.37-6.42 go on to say that selecting small sample sizes to test of details with low dollar value and from a large population generally do not by themselves provide sufficient evidence.

   d. Sections 6.45 does not require the use of statistical or non-statistical sampling. The factors to be considered in planning, designing, and evaluating audit samples are

discussed in SAS No. 39, ***Audit Sampling (AICPA Professional Standards Vol. I, AU Sec. 350).*** When planning to test a particular sample, the auditor should consider the specific audit objective to be achieved and should determine that the audit procedure, or combination of procedures, to be applied will achieve that objective. The size of a sample necessary to provide sufficient evidence depends on the objective and the efficiency of the sample.

e. Section 6.47 states that the auditor is not required to draw a separate sample for each major program. The SOP goes on to say the following:

> Experience has shown, however, that it is preferable to select separate samples from each major program because the separate sample provides clear evidence of the tests performed, the results of those tests, and the conclusions reached. If the auditor chooses to select audit samples from the entire universe of major program transactions, the working papers should be presented in such a fashion that they clearly indicate that the results of such samples, together with other evidence, are sufficient to support the opinion on each major program's compliance.

f. Section 6.47 also adds support for (c) above:

> As noted in paragraph 6.37, the auditor should be aware that a sample of a few items with a low dollar value and from a large population, generally does not, by itself, provide sufficient evidence.

g. Section 8.24 states that when evaluating the results of tests of controls, if or when the auditor is not able to support a low assessed level of control risk for major programs, the auditor is not required to expand his or her testing of internal control over compliance. The auditor, however, should assess the control risk at other than low, design tests of compliance accordingly, and consider the need to report an audit finding.

3. **Definition of Sampling**

SAS No. 39 (AU 350.01) defines audit sampling as follows:

> The application of an audit procedure to less than 100 percent of the items within an account balance or class of transactions for the purpose of evaluating some characteristics of the balance or class.

When an auditor uses audit sampling, the same basic requirements apply whether the approach to sampling is statistical or non-statistical. SAS No. 39 (AU 350.03) states:

> There are two general approaches to audit sampling: non-statistical and statistical. Both approaches require that the auditor use professional

judgement in planning, performing, and evaluating a sample. The guidance in this section applies equally to non-statistical and statistical sampling.

According to ***Practitioner's Guide to Audit Sampling***, by Dan M. Guy, Douglas R. Carmichael, and O. Ray Whittington, published in 1998 by John Wiley & Sons, Inc., whenever an auditor uses sampling (statistical or non-statistical), the following basic requirements apply:

a. **Planning.** When planning an audit sample, the auditor should consider the relationship of the sample to the relevant specific audit or internal control objective and consider certain other factors that influence sample size.

b. **Selection**. Sample items should be selected so that the sample can be expected to be representative of the population. All items in the population should have an opportunity to be selected.

c. **Evaluation**. The auditor should project the results of the sample to the items from which the sample was selected and consider the sampling risk. The auditor should also consider the qualitative aspects of the sample results.

The rationale of SAS No. 39 for imposing these basic requirements on all audit samples is that there is an underlying logic for sampling that holds true whether the sampling approach is statistical or non-statistical. SAS No. 39 recognizes that from a conceptual perspective, statistical sampling and non-statistical sampling are very similar. In fact, SAS No. 39 discusses sampling in general and makes few references to concepts or procedures unique to either type.

4. **OMB Circular A-133 Requires Internal Controls to be Assessed for a Low Level of Control Risk**

As stated previously, Section 500(c)(2)(i), requires that the auditor plan the testing of internal control over major programs to support a low assessed level of control risk and Section (c)(2)(ii) requires that testing of internal control should be performed as planned in (i).

The AICPA in the Audit and Accounting Guide ***Audit Sampling,*** identifies the following tolerable rates based on the dependence that an auditor wishes to place on internal controls. Since OMB Circular A-133 requires an assessment for a low level of risk, this equates to placing substantial reliance on the internal controls. Page 32 of ***Audit Sampling*** shows the tolerable rates:

Reliance on Internal Controls	**Tolerable Rate**
Substantial Reliance on internal control	2% to 7%
Moderate Reliance on internal control	6% to 12%
Little reliance on internal control	11% to 20%
No reliance	Omit test

For an auditor to make an assessment of internal controls for a low level of risk, the auditor should use tolerable rates between 2 percent and 7 percent. The ***Practitioner's Guide to Audit Sampling***, written by Dan M. Guy, Douglas R. Carmichael, and O. Ray Whittington, published in 1998 by John Wiley & Sons, Inc., on page 45, states the following:

> . . . If, for example, the auditor plans to assess control risk at a low level, and he or she desires a large degree of evidence from the sample (i.e., no other tests of controls for the assertion are planned), a tolerable rate of 5 percent or lower might be considered appropriate.

Another way of stating the above, is that if the auditor plans to perform no other substantive procedures other than the sample, the auditor should use a tolerable rate closer to 2 percent than to the 7 percent. The sample sizes associated with the tolerable rates between 2 percent and 7 percent are as follows (assuming a 95 percent Confidence Level and a .75 percent expected deviation rate):

Tolerable Rate	2%	3%	4%	5%	6%	7%
Sample Size	**	208	117	93	78	66

** Sample size would be too large to be cost effective.

5. **SAS No. 41, *Working Papers***

SAS No. 41 provides the guidance applicable, during the performance of the audits, on documentation of audit procedures (SAS No. 41, applicable during the period reviewed, has subsequently been superseded by SAS No. 96). **Section AU 339.05** states the following:

> Working papers ordinarily should include documentation showing that–
>
> a. The work has been adequately planned and supervised, indicating observance of the first standard of field work.
> b. A sufficient understanding of the internal control structure has been obtained to plan the audit and to determine the nature, timing and extent of tests to be performed.
> c. The audit evidence obtained, the auditing procedures applied, and the testing performed have provided sufficient competent evidential matter to afford a reasonable basis for an opinion, indicating observance of the third standard of field work.

Government Auditing Standards impose additional requirements with respect to working papers, and specifically requires auditors to document significant judgements made during the audit, including sampling criteria applied in audit samples. It states the following,

> Section 4.36: . . . working papers serve an additional purpose in audits performed in accordance with GAGAS. Working papers allow for the review of audit quality by

providing the reviewer written documentation of the evidence supporting the auditors' significant conclusions and judgments.

Section 4.37: Working papers should contain

a. the objectives, scope and methodology, including any sampling criteria used;
b. documentation of the work performed to support significant conclusions and judgments, including descriptions of transactions and records examined that would enable an experienced auditor to examine the same transactions and records, and
c. evidence of supervisory reviews of the work performed.

The AICPA's ***Audit Sampling*** (page 40) provides a listing of what the auditor should consider in documentation audit samples:

a. A description of the prescribed control procedure being tested.
b. The objective of the application, including its relationship to planned substantive testing.
c. The definition of the population and the sampling unit, including how the auditor considered completeness of the population.
d. The definition of the deviation condition.
e. The rationale for the risk of over-reliance, the tolerable deviation rate, and the expected population deviation rate used in the application.
f. The method of sample size determination.
g. A description of how the sampling procedure was performed and a list of compliance deviations identified in the sample.
h. The evaluation of the sample and a summary of the overall conclusion.

6. **SAS No. 39 (Dual-Purpose Samples)**

SAS No. 39 (AU 350.44) discusses dual-purpose testing:

> In some circumstances the auditor may design a sample that will be used for dual purposes: assessing control risk and testing whether the recorded monetary amount of transactions is correct. . . . The size of a sample designed for dual purposes should be the larger of the samples that would otherwise have been designed for the two separate purposes. In evaluating such tests, deviations from pertinent procedures and monetary misstatements should be evaluated separately using the risk levels applicable for the respective purposes.

7. **SAS No. 39, Significant Items**

SAS 39 (AU 350.21) states the following:

> As discussed in section 326, the sufficiency of tests of details for a particular account balance or class of transaction is related to the individual importance

> of the items examined as well as to the potential for material misstatement. When planning a sample for substantive test of details, the auditor uses judgement to determine which items, if any, in an account balance or class of transactions should be individually examined and which items, if any, should be subject to sampling. . . . For example, these may include items for which potential misstatement could individually equal or exceed the tolerable misstatement. Any item that the auditor has decided to examine 100 percent are not part of the items subject to sampling. Other items that in the auditor's judgement, need to be tested to fulfill the audit objective but need not be examined 100 percent, would be subject to sampling.

SOP 98-3, Section 6.37 states:

> In determining the nature, timing and extent of tests to perform, the auditor's professional judgment regarding the appropriate level of detection risk should be used. In applying this judgement, the auditor should be aware that small sample sizes for tests of details with a low dollar value and from a large population generally do not, by themselves, provide sufficient evidence. In determining the nature, timing, and extent of the testing of compliance, the auditor should consider audit risk and materiality related to each major program.

SOP 98-3 also states that small samples from large universes with small dollar value may not provide sufficient evidence. SAS 39 (AU 350.21) states that the auditor should first audit the significant items then apply sampling.

8. **Common System of Internal Controls**

A common system of internal controls has been defined as one in which one person may administer more than one major program. That person may approve expenditures or eligibility considerations, or prepare the various reports.

If a common system is in place for major programs, then the auditor may select the sample from the total universe of major programs rather than a separate sample for each. This position is supported by SOP 98-3 paragraph 6.47 (Exhibit II, item 17).

9. **Probability of Finding Errors Based on Sample Size**

The following information was derived from a statistical projection table designed by Dr. James Lackritz, Chairman of the IDS Department, College of Business Administration, San Diego State University.

Universe	2,500 transactions							
Materiality	4%							
Estimated Errors	100							
Sample	**10**	**15**	**20**	**25**	**30**	**35**	**40**	**60**
Probability of finding one error	**34%**	**46%**	**56%**	**64%**	**71%**	**76%**	**80%**	**92%**
Probability of finding two errors	**6%**	**12%**	**19%**	**26%**	**34%**	**41%**	**48%**	**70%**
Audit Risk based on The sample	**66%**	**54%**	**44%**	**36%**	**29%**	**24%**	**19%**	**8%**