ARIZONA Auditor General
Making a Positive Difference

Financial report user guide

Internal control and compliance reports

Understanding how to extract information from a government's annual single audit report is important when evaluating state or local government (government) financial performance, internal controls, and compliance with laws, regulations, contracts, and grant agreements. This user guide describes the internal control and compliance reports over the annual financial report and over federal programs and can help decision-makers identify and understand the important and useful information presented in these 2 reports, which are included in the single audit report.



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Single audit report can help decision-makers better govern state and local governments

The single audit report provides useful information about a government's annual financial performance, whether it has effective internal control procedures, and whether it has complied with certain state and federal laws and regulations, contracts, and grant agreements. The report includes information prepared by the government and its independent auditors, such as the Arizona Auditor General. The textbox to the right explains our role as an independent auditor.

A single audit is intended to be a cost-effective alternative to multiple individual federal program audits. The Single Audit Act requires nonfederal entities—such as state and local governments—to issue a single audit report that includes an audited annual financial report and schedule of federal programs along with the independent auditors' internal control and compliance reports over the financial report and federal programs.

The single audit report contains 3 key reports about a government's financial operations. First, the annual financial report provides useful information for understanding the government's financial structure, strategy, and performance. We issued guides describing how to use an annual financial report (see the *Financial report user guide—State and local governments* and the *Financial report user guide—Community colleges and universities* for more information on the annual financial report's key components).

About our Office

The Arizona Auditor General serves as an independent source of impartial information concerning State and local government entities.

The Arizona Auditor General conducts annual financial and compliance audits of State agencies, counties, community college districts, and universities in accordance with generally accepted auditing standards. Our reports provide the Legislature and other governing bodies with information on the receipt and use of public monies, provide specific recommendations to strengthen internal controls over assets and financial transactions, and help ensure compliance with applicable State and federal laws and regulations, contracts, and grant agreements.

Single audit report

All nonfederal entities that spend $1 million or more of federal program monies are required to obtain an annual audit in accordance with the Single Audit Act Amendments of 1996 and the audit requirements of Title 2 U.S. Code of Federal Regulations Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance). While the Single Audit Act mandates the audit, Uniform Guidance provides the detailed rules for how the audit must be performed, pre- and post-award requirements, and cost principles.

The 2 other reports focus on internal control and compliance related to the annual financial report and federal programs. This user guide focuses on these 2 other reports, which may be issued separately or together.

These 2 reports contain the following key information and are explained in further detail in the sections that follow:

- **Internal control and compliance report over the annual financial report** contains information about whether auditors found significant problems with the government's internal control procedures over its annual financial report preparation; whether auditors found noncompliance with certain laws, regulations, contracts, and grant agreements that could affect the government's financial statement amounts; and if necessary, the government's planned actions to correct any identified internal control deficiencies or noncompliance.

- **Internal control and compliance report over federal programs** contains information about whether auditors found significant problems with the government's internal control procedures over administering and complying with certain federal laws and regulations, contracts, and grant agreements; an audit opinion on whether the government complied with federal laws and regulations, contracts, and grant agreements and properly prepared a schedule of its federal programs; and if necessary, the government's planned actions to correct any identified internal control deficiencies or noncompliance.

Internal control and compliance report over the annual financial report

The internal control and compliance report over the annual financial report, generally known as the "Yellow Book Report," presents important information about issues that had or could have had a significant effect on the government's financial statements. It is required for audits performed in accordance with *Government Auditing Standards* (GAS), issued by the U.S. Comptroller General. The Yellow Book Report is presented in 3 sections: the independent auditors' report, the schedule of findings and recommendations, and the government's response, which are explained below and on pages 4 through 6.

Independent auditors' report

Auditors prepare and issue the independent auditors' report to present the results of testing internal control and compliance during a government's financial statement audit.

Two important things can be learned from the independent auditors' report:

- Whether auditors identified any financial-related internal control deficiencies during the government's financial statement audit (see textbox to the right).

- Whether auditors identified instances of noncompliance with laws, regulations, contracts, and grant agreements that did or could significantly affect the government's financial statements.

Financial-related internal controls and deficiencies

Financial-related internal controls include procedures or systems designed to:

- Safeguard assets and resources.
- Deter and detect errors, fraud, and theft.
- Produce reliable and complete financial information.

Financial-related internal control deficiencies exist when the design or operation of a control does not allow management or employees to prevent or detect financial misstatements in a timely manner.

The impact or potential impact on the government's financial statements from internal control deficiencies or noncompliance that auditors found is explained below and on pages 5 and 6 in the schedule of findings and recommendations section.

GAS does not require that auditors provide an opinion on the effectiveness of the government's overall internal control. However, GAS requires auditors to consider internal control and report internal control deficiencies they discover during the government's financial statement audit. The government's management is responsible for designing and implementing effective internal controls.

Similarly to internal control, GAS does not require that auditors express an opinion on the government's overall compliance with laws, regulations, contracts, and grant agreements. However, GAS requires auditors to consider noncompliance and perform tests of compliance with laws, regulations, contracts, and grant agreements that could have a significant effect on the government's financial statement amounts, such as a county's compliance with laws regarding the appropriate use of Highway User Revenue Fund monies. See page 6, the internal control and compliance report over federal programs section, for information about auditors' testing responsibilities and reports relating to a government's federal programs.

Auditors may report 2 types of financial-related internal control deficiencies: material weakness and significant deficiency (see textbox to the right). Auditors may also report any significant noncompliance with laws, regulations, contracts, and grant agreements. The report presents the number and types of control deficiencies that auditors found and auditors assign each finding an identifying number. If auditors did not find any internal control deficiencies or noncompliance with laws, regulations, contracts, and grant agreements during the government's financial statement audit, the report will indicate that instead.

Financial-related internal control deficiency types

Material weakness

A deficiency, or combination of deficiencies, in internal control where there is a reasonable possibility that the government's financial statements will contain incorrect information.

Significant deficiency

A deficiency, or combination of deficiencies, in internal control that is less severe than a material weakness but important enough to communicate to decision makers.

Schedule of findings and recommendations

The schedule of findings and recommendations is prepared by the auditors and specifically describes the internal control deficiencies and noncompliance with laws, regulations, contracts, and grant agreements auditors found during the government's financial statement audit. As shown in the example on pages 5 and 6, each finding is presented in 6 sections, including a description of what the auditors found, a recommendation to help fix the deficiency, and whether the finding was previously reported (see descriptions of each section on page 5). When the Yellow Book Report and the internal control and compliance report over federal programs are issued together, the financial-related findings are included on the schedule of findings and questioned costs. For more information on the schedule of findings and questioned costs, see page 11.

The 6 sections of each finding:

- **Condition—**What happened or what auditors found.
- **Effect—**The impact it could have on the financial statements and potential risks to the government.
- **Cause—**Why it happened.
- **Criteria—**What should be happening.
- **Recommendation—**What auditors recommend to correct the deficiency.
- **Views of responsible officials—**States whether management concurs with the finding.

Example of a reported internal control deficiency over financial reporting

Financial Statement Finding: 20XX-01

The government's control procedures over IT systems and data were insufficient, increasing the risk that the government may not adequately protect those systems and data.

Condition

The government's control procedures were not sufficiently implemented to respond to risks associated with its information technology (IT) systems and data.

Effect

There is an increased risk that the government may not adequately protect its IT systems and data, which could result in unauthorized or inappropriate access and/or the loss of confidentiality or integrity of systems and data.

Cause

The government reported that its IT department was understaffed and that it did not have the resources to develop policies and procedures.

Criteria

Implementing effective internal controls that follow a credible industry source, such as the National Institute of Standards and Technology, help the government protect its IT systems and ensure the integrity and accuracy of the data it maintains as it seeks to achieve its financial reporting, compliance, and operational objectives.

Example of a reported internal control deficiency over financial reporting, continued

Recommendations

1. Make it a priority to implement its comprehensive IT policies and procedures over access controls, and develop a process to ensure the procedures are being consistently followed.

2. Monitor government employees' adherence to the IT policies and procedures on a periodic basis to ensure they are consistently followed, and inform employees of updates to the policies and procedures throughout the year.

Views of responsible officials

Government management concurs with this finding. The government's corrective action plan at the end of this report includes the views and planned corrective action of its responsible officials regarding these recommendations. We are not required to audit and have not audited these responses and planned corrective actions and therefore provide no assurances as to their accuracy.

Government's response

The government's response and corrective action plan present how the government plans to correct each internal control deficiency or instance of noncompliance and the anticipated correction date, or an indication that the government's management disagrees with auditors' assessments. Auditors will also report if the government's corrective action does not adequately address auditors' recommendations or if auditors do not agree with the government's interpretation of the internal control deficiency or instance of noncompliance.

Internal control and compliance report over federal programs

The internal control and compliance report over federal programs, generally known as the "Uniform Guidance Report," presents information about the government's federal compliance audit. It is required for audits performed in accordance with Title 2 U.S. Code of Federal Regulations Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance) for federal awards.

The Uniform Guidance Report is presented in 4 sections: independent auditors' report, schedule of expenditures of federal awards, schedule of findings and questioned costs, and the government's response, which are explained on the following pages.

Independent auditors' report

Auditors prepare and issue the independent auditors' report, which contains 3 sections: (1) the report on federal compliance, (2) the report on federal-related internal controls, and (3) the auditors' opinion on the schedule of expenditures of federal awards.

Report on federal compliance section

Presents the auditors' opinion regarding the government's compliance for each of its major federal programs (see textbox to the right).

Three important things can be learned from the report on federal compliance section:

- Auditors' opinion as to whether the government complied with federal program requirements, such as allowable costs and expenditure reporting requirements, for each of the government's major federal programs.
- Management's responsibility for compliance with the requirements of laws, regulations, contracts, and grants applicable to the government's federal programs.
- Auditors' responsibilities for expressing an opinion on compliance for each of the government's major federal programs, including (1) how auditors are required to follow U.S. generally accepted auditing standards, GAS, and Uniform Guidance audit requirements, and (2) how auditors evaluate compliance on a test basis.

The auditors' opinion included in the report on federal compliance section will be 1 of 4 types—unmodified, often referred to as a "clean" audit opinion, and 3 types of modified opinions including qualified, adverse, and disclaimer of opinion (see textbox to the right). Government leaders can confidently show that they complied in all material respects

Major federal programs

Auditors select federal programs to audit based on the amount of federal monies spent during the year and the risk of federal noncompliance. Factors considered in determining the risks of federal noncompliance include the last year the program was audited, whether deficiencies were reported in the prior-year audit, and whether a federal agency has identified a program as higher risk.

Types of federal compliance audit opinions

Unmodified opinion

The government complied with federal requirements applicable to the major federal program.

Modified opinions

- **Qualified**

  With the exception of the compliance issues identified, the government complied with the major federal program's requirements.

- **Adverse**

  Because of the noncompliance identified, the government did not comply with the major federal program's requirements.

- **Disclaimer of opinion**

  Auditors could not obtain enough evidence to issue an opinion on whether the government complied with the major federal program's requirements.

with the federal laws and regulations, contracts, and grant agreements for each major federal program when an unmodified opinion is issued. When auditors report a modified opinion on a major federal program, the report will briefly discuss the reason and direct decision-makers to the finding detail where they can learn more about why the noncompliance was significant.

Auditors will also disclose if they found any other less significant instances of federal noncompliance that did not result in a major federal program's opinion modification. Although this noncompliance did not cause auditors to modify the major federal program's audit opinion, it is still important and required to be reported by federal audit requirements. For example, it might include noncompliance involving smaller dollar amounts that were not spent in accordance with a major federal program's requirements.

Report on federal-related internal controls section

Presents federal-related internal control deficiencies auditors found for each of the government's major federal programs (see textbox to the right).

Three things can be learned from the report on federal-related internal controls:

- Management's responsibility for establishing and maintaining controls to ensure compliance with federal laws and regulations, contracts, grant agreements, and major federal program requirements.
- The auditors' responsibility for assessing the government's federal-related internal controls for each major federal program.
- Whether the government had significant federal-related internal control deficiencies (see textbox to the right).

Similar to the Yellow Book Report explained on page 4, auditors are not required to express an opinion on the effectiveness of the government's overall federal-related internal control. However, under the Uniform Guidance audit requirements, auditors must evaluate federal-related internal controls related to the government's administration of federal grant programs and report control deficiencies they discover.

Federal-related internal controls and deficiencies

Federal-related internal controls

Include procedures or systems that are designed to:

- Reasonably ensure compliance with federal laws and regulations, contracts, grant agreements, and major federal program requirements.
- Safeguard assets purchased with federal monies.
- Prevent and detect fraud and abuse.

Federal-related internal control deficiencies

Exist when the design or operation of a control does not allow management or employees to prevent or detect noncompliance with federal laws and regulations, contracts, grant agreements, and major federal program requirements in a timely manner.

Auditors report 2 types of federal-related internal control deficiencies: material weakness and significant deficiency (see textbox below). The independent auditors' report section of the Uniform Guidance Report presents the number and types of control deficiencies that auditors found and auditors assign each deficiency an identifying number. If auditors did not find any deficiencies during the government's federal audit, the report will indicate that instead.

Federal-related internal control deficiency types

Material weakness

A deficiency, or combination of deficiencies, in internal control where there is a reasonable possibility that noncompliance with a major federal program's requirements will not be prevented, detected, or corrected on a timely basis, such as management not being knowledgeable about the major federal program's requirements and not reviewing spending activity for allowable costs.

Significant deficiency

A deficiency, or combination of deficiencies, in internal control that is less severe than a material weakness but important enough to communicate to decision-makers, such as management not reviewing all required expenditure reports for accuracy before submitting them to the federal agency.

Auditors' opinion on the Schedule of Expenditures of Federal Awards (SEFA) section

This section presents (1) management's responsibility to prepare the SEFA—a schedule required by Uniform Guidance that includes information about the federal monies the government spent during the fiscal year—and (2) the auditors' opinion on whether the financial information presented on the government's SEFA is accurate. Similar to the federal compliance audit opinion explained on pages 7 and 8, government leaders can confidently show that they presented the SEFA in accordance with federal laws in all material respects when auditors issue an unmodified opinion on it. In addition, an unmodified opinion allows decision-makers to evaluate their government's federal spending knowing that the information on the SEFA is accurate. When auditors issue a modified opinion on the SEFA, the auditors' report will discuss the reason for the modification, such as management incorrectly reporting the amount of federal dollars the government spent during the year.

Schedule of Expenditures of Federal Awards (SEFA)

The SEFA is prepared by the government's management and presents information about federal monies the government spent during the fiscal year. Management uses the *Federal Assistance Listings* (FAL) to help prepare the SEFA (see textbox to the right). The FAL can also be used to help decision-makers understand the purpose or goals of federal programs the government administers.

The Federal Assistance Listings (FAL)

The FAL is an online database that provides a full listing of federal programs available to state and local governments. Each federal program is assigned a FAL number, which can be used to look up federal program information, such as the program's objectives and federal requirements, online at https://sam.gov/assistance-listings.

Five important things can be learned from the SEFA (see SEFA example below):

- The total amount of federal program dollars the government spent during the year.
- The federal programs the government administers, such as the Homeland Security Grant Program, and how much was spent for each program during the year.
- Each federal agency, such as the Department of Justice, that funded each of the government's federal programs.
- Federal monies that the government received from a pass-through grantor, such as the Arizona Department of Public Safety providing federal program monies to a county to achieve the federal program's goals.
- The federal dollars the government provided to subrecipients, such as a county that provided Crime Victim Assistance federal program monies to a local city to achieve the federal program's goals.

Example presenting portions of a government-prepared SEFA

Federal agency/ Assistance Listings number	Federal program name	Cluster title	Pass-through grantor	Pass-through grantor's number(s)	Program expenditures	Amount provided to subrecipients
Department of Justice						
16.575	Crime Victim Assistance		Arizona Department of Public Safety	2012-02	$480,000	$150,000
Total Department of Justice					$480,000	$150,000
Department of Labor						
17.258	WIOA Adult Program	WIOA Cluster	Arizona Department of Economic Security	DE454-12	$560,000	
17.259	WIOA Youth Activities	WIOA Cluster	Arizona Department of Economic Security	DE454-13	$700,000	
17.278	WIOA Dislocated Worker Formula Grants	WIOA Cluster	Arizona Department of Economic Security	DE454-14	$650,000	
Total Department of Labor					$1,910,000	
Environmental Protection Agency						
66.001	Air Pollution Control Program Support		Arizona Department of Health Services	K556-121	$350,000	
Total Environmental Protection Agency					$350,000	

Schedule of findings and questioned costs

The schedule of findings and questioned costs is prepared by auditors and presents the overall results from the government's financial statement and federal compliance audits during the year. It has 3 important sections: the summary of auditors' results, the financial statement findings, and the federal award findings and questioned costs.

Summary of auditors' results

Presents a summary of what the auditors found during the government's financial and federal audits.

Financial statement findings

Presents or refers to the findings reported in the internal control and compliance report over the annual financial report (see pages 3 through 6).

Federal award findings and questioned costs

Describes each internal control deficiency and instance of noncompliance auditors found during the government's federal compliance audit, including whether there were any questioned costs resulting from the noncompliance (see textbox to the right). The details of federal award findings are presented similar to financial-related findings and include the 6 sections as explained on page 5. See page 12 for an example of a federal award finding and questioned costs.

Federal questioned costs

Questioned costs include federal monies the government spent that did not comply with a major federal program's federal compliance requirements. Federal regulations require auditors to report questioned costs that exceed $25,000.

Four important things can be learned from each federal award finding:

- The applicable major federal program, the federal agency that funded the program, and the award period.
- The federal compliance requirement the government did not comply with (see textbox on page 13).
- Specific questioned costs, if any, that resulted from the noncompliance.
- A description of the finding and the auditors' recommendation (see page 5 for information about the 6 sections of each finding).

Example of a federal award finding

Federal Award Finding and Questioned Costs: 20XX-1XX

The government did not request reimbursement of federal monies based on actual costs, receiving $25,250 more than it was entitled to

Assistance Listings number and name:	93.069 Public Health Emergency Preparedness
Award number and year:	Award #1, July 1, 20XX through June 30, 20XX
Federal agency:	U.S. Department of Health and Human Services
Compliance requirement:	Cash management
Questioned costs:	$25,250

Condition

The government submitted a reimbursement request for $25,250 of costs that had been budgeted but not paid to administer the grant.

Effect

The government received $25,250 in federal monies it was not entitled to and will need to work with the federal agency to return or otherwise resolve the overpayment.

Cause

The government did not have policies and procedures to ensure that reimbursement requests were based on costs paid to administer the grant, including requiring independent reviews of the reimbursement requests prior to submitting the request to the federal government for reimbursement.

Criteria

Uniform Guidance and the government's federal program grant agreement require it to request reimbursement only for actual costs paid to administer the Public Health Emergency Preparedness program. Further, federal regulation requires establishing and maintaining effective internal control over federal awards that provides reasonable assurance that the federal program is being managed in compliance with all applicable laws, regulations, and award terms (2 Code of Federal Regulations §200.303).

Recommendations to the government

1. Request reimbursement only for actual costs paid to administer the grant.
2. Develop and implement policies and procedures for employees to follow when preparing and reviewing reimbursement requests.

Views of responsible officials

Government management concurs with this finding. The government's corrective action plan at the end of this report includes the views and planned corrective action of its responsible officials regarding these recommendations. We are not required to audit and have not audited these responses and planned corrective actions and therefore provide no assurances as to their accuracy.

Federal compliance requirements

Federal compliance requirements include laws and regulations applicable to federal programs that are established by federal government agencies. Governments must comply with these requirements to receive federal monies. Common federal compliance requirements include:

- **Cash management**

  Such as requiring the government to request reimbursement for costs that have been incurred and paid.

- **Cost sharing**

  Such as requiring a government to use its own funds to pay for a percentage of the federal program's activities.

- **Costs and activities allowed**

  Such as whether monies may be spent on certain items.

- **Equipment**

  Such as requiring the government to safeguard and account for all equipment purchased with federal monies.

- **Reporting**

  Such as reporting monthly expenditures.

- **Subrecipient monitoring**

  Such as the government performing onsite visits of its subrecipients or reviewing supporting documentation prior to reimbursing the subrecipient for its program expenditures.

Government's response

Governments are required to respond to federal internal control and compliance findings in 2 ways: (1) by providing a corrective action plan and (2) by providing a summary schedule of prior audit findings.

Similar to the government's response and corrective action plan in the report on internal control and on compliance over the annual financial report (see page 6), the corrective action plan presents how the government intends to correct each federal finding and the anticipated completion date or an indication that the government's management disagrees with the auditors' assessment. Auditors should also report if the government's corrective action does not adequately address its recommendations or if they do not agree with the government's interpretation. The summary schedule of prior audit findings reports on whether findings found during the government's prior-year audits have been corrected or are in the process of being corrected.