

## Internal control and compliance reports user guide

Understanding how to extract information from a government's annual single audit reporting package is important when evaluating state or local government (government) financial performance, internal controls, and compliance with laws and regulations. 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 two reports, which are included in the single audit reporting package.

### Single audit reporting package can help decision makers better govern state and local governments

The single audit reporting package 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 (see textbox below). The reporting package includes information prepared by the government and its independent auditors, such as the Arizona Office of the Auditor General. The textbox to the right explains our Office's role as an independent auditor.

The single audit reporting package contains three 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. Our Office 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 Office of the Auditor General serves as an independent source of impartial information concerning state and local government entities.

The Office 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.

#### Single audit reporting package

All nonfederal entities that spend \$750,000 or more of federal program monies are required to obtain an annual audit in accordance with the Single Audit Act Amendments of 1996. 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 reporting package 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 two other reports focus on internal control and compliance related to the annual financial report and federal programs. This user guide focuses on these two other reports, which may be issued separately or together. These two 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 and regulations that could have an effect on 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, an audit opinion on whether the government complied with federal laws and regulations and properly prepared a schedule of its federal programs, and if necessary, the government’s planned actions to correct any identified internal control weaknesses or noncompliance.

## Internal control and compliance report over the annual financial report— Yellow Book 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 Comptroller General of the United States.

The Yellow Book Report is presented in three sections: the independent auditors’ report, the schedule of findings and recommendations, and the government’s response, which are explained below.

### 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 that 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 and regulations 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; and
- 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 on page 3 in the schedule of findings and recommendations section.

GAS do not require that auditors provide an opinion on the effectiveness of the government’s overall internal control. However, GAS require 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 do not require that auditors express an opinion on the government’s overall compliance with laws and regulations. However, GAS require auditors to consider noncompliance and perform tests of compliance with laws and regulations 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. For information about auditors’ testing responsibilities and reports relating to a government’s federal programs, see page 4, the internal control and compliance report over federal programs section.

Auditors may report two 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 and regulations. 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 and regulations during the government's financial statement audit, the report will indicate that instead.

## 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 and regulations auditors found during the government's financial statement audit. As shown in the example below, each finding is presented in five sections, including a description of what the auditors found and a recommendation to help fix the deficiency (see textbox to the right for the description of each section). 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 7.

## 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.

## The five sections of each finding

**Criteria**—What should be happening.

**Condition/context**—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.

**Recommendation**—What auditors recommend to correct the deficiency.

## Example of a reported internal control deficiency over financial reporting

**2014-01**

### The government should improve its controls over IT system access

**Criteria**—The government should have internal control policies and procedures that prevent unauthorized use or manipulation of its IT systems.

**Condition and context**—The government does not have policies and procedures that prevent unauthorized use or manipulation of its IT systems.

**Effect**—The government's important data may be altered or used inappropriately.

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

**Recommendation**—To help prevent unauthorized use or manipulation of its important data, the government should develop and implement policies and procedures for preventing unauthorized use or manipulation of its IT systems.

## Government's response

The government's response section presents 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 Single Audit Report

The internal control and compliance report over federal programs, generally known as the “Single Audit Report,” presents information about the government's federal compliance audit. It is required for audits performed in accordance with the U.S. Office of Management and Budget's (OMB) audit guidance for federal awards. The OMB federal audit requirements stipulate that governments that spend at least \$750,000 of federal monies in a fiscal year must have auditors conduct a federal compliance audit.

The Single Audit Report is presented in four sections: independent auditors' report, schedule of expenditures of federal awards, schedule of findings and questioned costs, and the government's response, which are explained below.

### Independent auditors' report

Auditors prepare and issue the independent auditors' report, which contains three 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).

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

- 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 OMB federal audit requirements, and (2) how auditors evaluate compliance on a test basis.
- 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.
- Auditors' report on identifying whether the government had internal control deficiencies within any of its major federal programs.

The auditors' opinion included in the report on federal compliance section will be one of four types—unmodified, often referred to as a “clean” audit opinion, and three types of modified opinions—qualified, adverse, and disclaimer of opinion (see textbox to the right). Government leaders can confidently show that they complied with the federal laws and regulations 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

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

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 that 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, regulations, 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 2, auditors are not required to express an opinion on the effectiveness of the government's overall federal-related internal control. However, under OMB's federal 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 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.

### **Federal-related internal controls and deficiencies**

**Federal-related internal controls**—Include procedures or systems that are designed to:

- Reasonably ensure compliance with federal laws, regulations, and major federal program requirements;
- Safeguard assets purchased with federal monies; and
- 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, regulations, and major federal program requirements in a timely manner.

Auditors report two types of federal-related internal control deficiencies: material weakness and significant deficiency (see textbox to the left). The independent auditors' report section of the Single Audit 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.

### **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 OMB's federal guidelines 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. The SEFA is further explained in the following section.

Similar to the federal compliance audit opinion explained on page 4, government leaders can confidently show that they presented the SEFA in accordance with federal laws 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 Catalog of Federal Domestic Assistance (CFDA) to help prepare the SEFA (see textbox to the right). The CFDA can also be used to help decision makers understand the purpose or goals of federal programs the government administers.

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

### The Catalog of Federal Domestic Assistance (CFDA)

The CFDA is an online database that provides a full listing of federal programs available to state and local governments. Each federal program is assigned a CFDA number, which can be used to look up federal program information, such as the program's objectives and federal requirements, online at [www.cfda.gov](http://www.cfda.gov).

- The total amount of federal program dollars the government spent during the year.
- The federal programs, such as the Homeland Security Grant Program, the government administers 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 Homeland Security 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 Public Health Emergency Preparedness federal program monies to a local city to achieve the federal program's goals.

### Example presenting portions of a government-prepared SEFA

Federal agency/CFDA number	Federal program name	Cluster title	Pass-through grantor	Pass-through grantor's number(s)	Program expenditures	Amount provided to subrecipients
<b>Department of Justice</b>						
16 575	Crime Victim Assistance		Arizona Department of Public Safety	2012-02	\$ 480,000	
<b>Department of Labor</b>						
17 258	WIA Adult Program	Workforce Investment Act (WIA) Cluster	Arizona Department of Economic Security	DE454-12	560,000	
17 259	WIA Youth Activities	Workforce Investment Act (WIA) Cluster	Arizona Department of Economic Security	DE454-13	700,000	
17 278	Workforce Investment Act-Dislocated Workers	Workforce Investment Act (WIA) Cluster	Arizona Department of Economic Security	DE454-14	650,000	
	<b>Total Department of Labor</b>				<u>1,910,000</u>	
<b>Environmental Protection Agency</b>						
66 001	Air Pollution Control Program		Arizona Department of Health Services	K556-121	350,000	
<b>Department of Health and Human Services</b>						
93 069	Public Health Emergency Preparedness				360,000	\$ 65,000
<b>Department of Homeland Security</b>						
97 067	Homeland Security Grant Program		Arizona Department of Homeland Security	88840-01	800,000	
	<b>Total expenditures of federal awards</b>				<u>\$ 3,900,000</u>	<u>\$ 65,000</u>

## 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 three important sections: the summary of auditors' results, the financial statement findings, and the federal award findings with 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 2 through 3).

**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 five sections as explained and illustrated on page 3. An example of a federal award finding and questioned costs is illustrated below.

### 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 laws and requirements require auditors to report noncompliance that resulted in questioned costs of \$25,000 or more.

### Example of a federal award finding

#### Finding No. 2014-101

<b>CFDA No. and Name:</b>	93.069 <b>Public Health Emergency Grant</b>
<b>Award Number and Year:</b>	Award #1, July 1, 2014 through June 30, 2015
<b>Federal Agency:</b>	<b>Department of Health and Human Services</b>
<b>Compliance Requirement:</b>	Cash Management
<b>Questioned Costs:</b>	\$25,250

**Criteria**—In accordance with the federal program grant agreement, the government should request reimbursement only for actual costs paid to administer the Public Health Emergency Grant.

**Condition and context**—The government submitted a reimbursement request for costs that had been budgeted but not paid to administer the grant.

**Effect**—The government requested reimbursement for and received \$25,250 more than it spent.

**Cause**—The government did not have policies and procedures to ensure that reimbursement requests were based on costs paid to administer the grant.

**Recommendation**—To help ensure that the government requests reimbursement only for costs that have been paid, the government should develop and implement policies and procedures for employees to follow when preparing and reviewing reimbursement requests.

## Four important things that 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 below).
- Specific questioned costs, if any, that resulted from the noncompliance.
- A description of the finding and the auditors' recommendation (see page 3 for information about the five sections of each finding).

### 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:

**Costs and activities allowed**—Such as whether monies may be spent on certain items.

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

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

**Reporting**—Such as reporting monthly expenditures.

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

### Government's response

Governments are required to respond to federal internal control and compliance findings in two 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 section in the report on internal control and on compliance over the annual financial report (see pages 3 through 4), 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.