United States General Accounting Office

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By the Comptroller General of the United States

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Government Auditing Standards

Amendment No. 1

Documentation Requirements When Assessing Control Risk at Maximum for Controls Significantly Dependent Upon Computerized Information Systems

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GAO

United States
General Accounting Office
Washington, D.C. 20548

Comptroller General
of the United States

This Statement, the first amendment to *Government Auditing Standards* (1994 version), commonly known as the Yellow Book, amends the section entitled "Internal Control" (paragraphs 4.21 through 4.33) in chapter 4. It establishes a new field work standard requiring documentation in the planning of financial statement audits in certain circumstances (paragraphs 4.21.1 through 4.21.4). Specifically, this new standard requires auditors to document in the working papers the basis for assessing control risk at the maximum level for assertions related to material account balances, transaction classes, and disclosure components of financial statements when such assertions are significantly dependent on computerized information systems. It also requires auditors to document their consideration that the planned audit procedures are designed to achieve audit objectives and to reduce audit risk to an acceptable level.

The American Institute of Certified Public Accountants (AICPA), in issuing Statement on Auditing Standards (SAS) No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55,* requires auditors to document their basis for conclusions when control risk is assessed below maximum. However, SAS No. 78 does not impose a similar requirement for assessments of control risk at maximum. This new standard will impose such a requirement for assertions related to material account balances, transaction classes, and disclosure components of financial statements when such assertions are significantly dependent on computerized information systems.

The Advisory Council on Government Auditing Standards recommended the issuance of this new standard in order to tighten the rigor applied to an audit of the financial statements when computerized information systems are used in significant accounting applications. The new standard should heighten auditors' awareness of the risks associated with auditing in the environment of computerized information systems that is pervasive today. The standard reflects the Council's viewpoint that requiring auditors to document their basis for assessing control risk at maximum and the planned audit procedures that relate to that decision will help ensure that auditors do not inadvertently rely on computer-generated evidence in conducting substantive testing. The intent of this standard is not to replace auditors' judgment in planning the audit, but to assist auditors in assuring the soundness of their planned audit procedures when significant accounting applications are supported by computerized information systems.

This standard also incorporates, where applicable, conforming changes to recognize the effect of SAS No. 78 on *Government Auditing Standards* for internal control. These changes principally affect paragraphs 4.22 through 4.33 and consist of updating terminology to conform with SAS No. 78 and deleting guidance that is addressed in SAS No. 78, which was issued after the 1994 revision of *Government Auditing Standards*. In addition, we have amended the section entitled "Relation to AICPA Standards" (paragraphs 4.2 through 4.5) to reflect changes in conforming language as well as changes in paragraph numbers resulting from the addition of the new field work standard.

We have included as appendix I a version of the standard which shows the deletion of language appearing in the 1994 Yellow Book with a strikeout and presents the new or amended language with bold and italics. Appendix II contains a list of members of the Comptroller General's Advisory Council on Government Auditing Standards.

An electronic version of this standard can be accessed through the U.S. General Accounting Office's (GAO) Internet Home Page (***www.gao.gov***) from the GAO Policy and Guidance Materials or the Special Publications sections of the GAO site, or directly at ***www.gao.gov/govaud/ybk01.htm***. This site also contains a new electronic version of *Government Auditing Standards,* which codifies the new standard by reflecting changes made resulting from the issuance of these amendments. Printed copies of this standard can be obtained from the U. S. Government Printing Office.

This standard, the first amendment under the revised approach of issuing individual standards, was exposed for public comment prior to its final issuance. As a result, various suggestions were incorporated into the final standard. I thank those who suggested improvements to the standard, and I especially commend the Advisory Council on Government Auditing Standards and the project team for their efforts.

This standard is effective for financial statement audits of periods ending on or after September 30, 1999.

David M. Walker
Comptroller General
of the United States

Documentation Requirements When Assessing Control Risk at Maximum for Controls Significantly Dependent Upon Computerized Information Systems

This amendment to *Government Auditing Standards* (1994 revision) establishes a new field work standard to require documentation when assessing control risk at maximum for controls significantly dependent upon computerized information systems. This standard is effective for financial statement audits of periods ending on or after September 30, 1999.

Relation to AICPA Standards

4.2 For financial statement audits, generally accepted government auditing standards (GAGAS) incorporate the American Institute of Certified Public Accountants' (AICPA) three generally accepted standards of field work, which are:

a. The work is to be adequately planned and assistants, if any, are to be properly supervised.

b. A sufficient understanding of internal control is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.

c. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.

4.3 The AICPA has issued statements on auditing standards (SAS) that interpret its standards of field work (including a SAS on compliance auditing).[1] This chapter incoporates these SASs and prescribes additional standards on

a. audit follow-up (see paragraphs 4.7, 4.10, and 4.11);

b. noncompliance other than illegal acts (see paragraphs 4.13 and 4.18 through 4.20);

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[1]GAGAS incorporate any new AICPA standards relevant to financial statement audits unless the General Accounting Office (GAO) excludes them by formal announcement.

c. documentation of the assessment of control risk for assertions significantly dependent upon computerized information systems (see paragraphs 4.21.1 through 4.21.4); and

d. working papers. (See paragraphs 4.35 through 4.38.)

4.4 This chapter also presents discussions of three other key aspects of financial statement audits:

a. materiality (see paragraphs 4.8 and 4.9),

b. fraud and illegal acts (see paragraphs 4.14 through 4.17), and

c. internal control. (See paragraphs 4.22 and 4.25 through 4.30.)

4.5 This chapter concludes by explaining which standards auditors should follow in performing financial related audits.

Internal Control

4.21 AICPA standards and GAGAS require the following:

Auditors should obtain a sufficient understanding of internal control to plan the audit and determine the nature, timing, and extent of tests to be performed.

4.21.1 AICPA standards and GAGAS require that, in all audits, the auditor obtain an understanding of internal control sufficient to plan the audit by performing procedures to understand (1) the design of controls relevant to an audit of financial statements and (2) whether the controls have been placed in operation. This understanding should include a consideration of the methods an entity uses to process accounting information because such methods influence the design of internal control. The extent to which computerized information systems are used in significant accounting applications,[5.1] as well as the complexity of that processing, may also influence the nature, timing, and extent of audit procedures. Accordingly, in planning the audit and in obtaining an understanding of internal control over an entity's computer processing, the auditor should consider, among other things, such matters as

a. the extent to which computer processing is used in each significant accounting application;[5.2]

b. the complexity of the entity's computer operations;

c. the organizational structure of the computer processing activities; and

d. the kinds and competence of available evidential matter, in electronic and in paper formats, to achieve audit objectives.

4.21.2 AICPA standards and GAGAS require auditors to document their understanding of the components of an entity's internal control related to computer applications that process information used in preparing an entity's financial statements and, based on that

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[5.1]Significant accounting applications are those which relate to accounting information that can materially affect the financial statements the auditor is auditing. Significant accounting applications could include financial as well as other systems, such as management information systems or systems that monitor compliance, if they provide data for material account balances, transaction classes, and disclosure components of financial statements.

[5.2] Obtaining an understanding of these elements would include consideration of internal control related to security over computerized information systems.

understanding, to develop a planned audit approach in sufficient detail to demonstrate its effectiveness in reducing audit risk. In doing so, under AICPA standards and GAGAS, the auditor should consider whether specialized skills are needed for considering the effect of computerized information systems on the audit, understanding internal control, or designing and performing audit procedures, including tests of internal control. If the use of a professional with specialized skills is planned, the auditor should have sufficient computer-related knowledge to communicate the objectives of the other professional's work; to evaluate whether the specified procedures will meet the auditor's objectives; and to evaluate the results of the procedures applied as they relate to the nature, timing, and extent of other planned audit procedures.

4.21.3 The additional internal control standard for financial statement audits is

In planning the audit, auditors should document in the working papers (1) the basis for assessing control risk at the maximum level for assertions related to material account balances, transaction classes, and disclosure components of financial statements when such assertions are significantly dependent upon computerized information systems, and (2) consideration that the planned audit procedures are designed to achieve audit objectives and to reduce audit risk to an acceptable level.

4.21.4 This additional GAGAS standard does not increase the auditor's responsibility for testing controls, but rather requires that, if the auditor assesses control risk at the maximum level for assertions related to material account balances, transaction classes, and disclosure components of financial statements when such assertions are significantly dependent upon computerized information systems, the auditor should document in the working papers[5.3] the basis for that conclusion by addressing (1) the ineffectiveness of the design and/or operation of the controls, or (2) the reasons why it would be inefficient to test the controls. In such circumstances, GAGAS also require the auditor to document in the working papers the consideration that the planned audit procedures are designed to achieve specific audit objectives and, accordingly, to reduce audit risk to an acceptable level. This documentation should address

a. the rationale for determining the nature, timing, and extent of planned audit procedures;

b. the kinds and competence of available evidential matter produced outside a computerized information system; and

c. the effect on the audit opinion or report if evidential matter to be gathered during the audit does not afford a reasonable basis for the auditor's opinion on the financial statements.

4.22 Safeguarding of assets and compliance with laws and regulations are internal control objectives that are especially important in conducting financial statement audits in accordance with GAGAS of governmental entities or others receiving government funds. Given the public accountability for stewardship of resources, safeguarding of assets permeates control objectives and components as defined by the AICPA standards and GAGAS. Also, the operation of government programs

[5.3]See paragraphs 4.34 through 4.38 for a discussion of the working paper standards.

and the related transactions that materially affect the entity's financial statements are generally governed by laws and regulations. Although GAGAS are not prescribing additional internal control standards in these areas, this chapter provides a discussion that auditors may find useful in assessing audit risk and in obtaining evidence needed to support their opinion on the financial statements in a governmental environment.

[Paragraphs 4.23 and 4.24 deleted.]

Safeguarding of Assets

4.25 As applied to financial statement audits, internal control over safeguarding of assets constitutes a process, effected by an entity's governing body, management, and other personnel, designed to provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

4.26 Internal control over the safeguarding of assets relates to the prevention or timely detection of unauthorized transactions and unauthorized access to assets that could result in losses that are material to the financial statements; for example, when unauthorized expenditures or investments are made, unauthorized liabilities are incurred, inventory is stolen, or assets are converted to personal use. Such controls are designed to help ensure the use of and access to assets are in accordance with management's authorization. Authorization includes approval of transactions in accordance with control activities established by management to safeguard assets, such as establishing and complying with requirements for extending and monitoring credit or making investment decisions, and related documentation. Control over safeguarding of assets is not designed to protect against loss of assets arising from inefficiency or from management's operating decisions, such as incurring expenditures for equipment or material that proves to be unnecessary or unsatisfactory.

4.27 AICPA standards and GAGAS require auditors to obtain a sufficient understanding of internal control to plan the audit. They also require auditors to plan the audit to provide reasonable assurance of detecting material fraud, including material misappropriation of assets. Because preventing or detecting material misappropriations is an objective of control over safeguarding of assets, understanding this type of control can be essential to planning the audit.

4.28 Control over safeguarding of assets is not limited to preventing or detecting misappropriations, however. It also helps prevent or detect other material losses that could result from unauthorized acquisition, use, or disposition of assets. Such controls include, for example, the process of assessing the risk of unauthorized acquisition, use, or disposition of assets and establishing control activities to help ensure that management directives to address the risk are carried out. Such control activities would include permitting acquisition, use, or disposition of assets only in accordance with management's general or specific authorization, including compliance with established control activities for such acquisition, use, or disposition. They would also include comparing existing assets with the related records at reasonable intervals and taking appropriate action with respect to any differences. Finally, controls over safeguarding of assets against unauthorized acquisition, use, or disposition also relate to making available to management information it needs to carry out its responsibilities related to prevention or timely detection of such unauthorized activities, as well as mechanisms to enable management to monitor the continued effective operation of such controls.

4.29 Understanding the control over safeguarding of assets can help auditors assess the risk that financial statements could be materially misstated. For example, an understanding of an auditee's control over the safeguarding of assets can help auditors recognize risk factors such as

a. failure to adequately monitor decentralized operations;

b. lack of control over activities, such as lack of documentation for major transactions;

c. lack of control over computerized information systems, such as a lack of control over access to applications that initiate or control the movement of assets;

d. failure to develop or communicate adequate control activities for security of data or assets, such as allowing unauthorized personnel to have ready access to data or assets; and

e. failure to investigate significant unreconciled differences between reconciliations of a control account and subsidiary records.

Control Over Compliance With Laws and Regulations

4.29.1 Governmental entities are subject to a variety of laws and regulations that affect their financial statements, which is a major factor distinguishing governmental accounting from commercial accounting. For example, such laws and regulations may address the required fund structure, procurement or debt limitations, or authority for transactions. Accordingly, compliance with such laws and regulations may have a direct and material effect on the determination of amounts in the financial statements of governmental entities. Likewise, organizations that receive government assistance, such as contractors, nonprofit organizations, and other nongovernmental organizations, are also subject to regulations, contract provisions, or grant agreements that could have a direct and material effect on their financial statements. Management, of both governmental entities and others receiving governmental assistance, is responsible for ensuring that the entity complies with the laws and regulations applicable to its activities. That responsibility encompasses the identification of applicable laws and regulations and the establishment of controls designed to provide reasonable assurance that the entity complies with those laws and regulations.

4.30 AICPA standards and GAGAS require auditors to design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts. To meet that requirement, auditors should have an understanding of internal control relevant to financial statement assertions affected by those laws and regulations. Auditors should use that understanding to identify types of potential misstatements, consider factors that affect the risk of material misstatement, and design substantive tests. For example, the following factors may influence the auditors' assessment of control risk:

a. management's awareness or lack of awareness of applicable laws and regulations;

b. auditee policy regarding such matters as acceptable operating practices and codes of conduct; and

c. assignment of responsibility and delegation of authority to deal with such matters as organizational goals and objectives, operating functions, and regulatory requirements.

[Paragraphs 4.31 through 4.33 deleted.]

Documentation Requirements When Assessing Control Risk at Maximum for Controls Significantly Dependent Upon Computerized Information Systems

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Relation to AICPA Standards

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a. The work is to be adequately planned and assistants, if any, are to be properly supervised.

b. A sufficient understanding of ~~the~~ internal control ~~structure~~ is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.

c. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.

4.3 The AICPA has issued statements on auditing standards (SAS) that interpret its standards of field work (including a SAS on compliance auditing).[1] This chapter incorporates these SASs and prescribes additional standards on

[1]GAGAS incorporate any new AICPA standards relevant to financial statement audits unless the General Accounting Office (GAO) excludes them by formal announcement.

a. audit follow-up (see paragraphs 4.7, 4.10, and 4.11),

b. noncompliance other than illegal acts (see paragraphs 4.13 and 4.18 through 4.20), ~~and~~

c. ***documentation of the assessment of control risk for assertions significantly dependent upon computerized information systems (see paragraphs 4.21.1 through 4.21.4), and***

~~c.~~***d***. working papers. (See paragraphs 4.35 through 4.38.)

4.4 This chapter also presents ~~guidance on~~ ***discussions of*** three other key aspects of financial statement audits:

a. materiality (see paragraphs 4.8 and 4.9),

b. ~~irregularities~~ ***fraud*** and illegal acts (see paragraphs 4.14 through 4.17), and

c. internal control~~s~~. (See paragraphs 4.~~21~~***22 and 4.25*** through 4.~~33~~***30***.)

4.5 This chapter concludes by explaining which standards auditors should follow in performing financial related audits.

Internal Control~~s~~

4.21 AICPA standards and GAGAS require the following:

Auditors should obtain a sufficient understanding of internal control~~s~~ to plan the audit and determine the nature, timing, and extent of tests to be performed.

4.21.1 AICPA standards and GAGAS require that, in all audits, the auditor obtain an

understanding of internal control sufficient to plan the audit by performing procedures to understand (1) the design of controls relevant to an audit of financial statements and (2) whether the controls have been placed in operation. This understanding should include a consideration of the methods an entity uses to process accounting information because such methods influence the design of internal control. The extent to which computerized information systems are used in significant accounting applications,[5.1] as well as the complexity of that processing, may also influence the nature, timing, and extent of audit procedures. Accordingly, in planning the audit and in obtaining an understanding of internal control over an entity's computer processing, the auditor should consider, among other things, such matters as

a. the extent to which computer processing is used in each significant accounting application;[5.2]

b. the complexity of the entity's computer operations;

[5.1]Significant accounting applications are those which relate to accounting information that can materially affect the financial statements the auditor is auditing. Significant accounting applications could include financial as well as other systems, such as management information systems or systems that monitor compliance, if they provide data for material account balances, transaction classes, and disclosure components of financial statements.

[5.2]Obtaining an understanding of these elements would include consideration of internal control related to security over computerized information systems.

c. the organizational structure of the computer processing activities; and

d. the kinds and competence of available evidential matter, in electronic and in paper formats, to achieve audit objectives.

4.21.2 AICPA standards and GAGAS require auditors to document their understanding of the components of an entity's internal control related to computer applications that process information used in preparing an entity's financial statements and, based on that understanding, to develop a planned audit approach in sufficient detail to demonstrate its effectiveness in reducing audit risk. In doing so, under AICPA standards and GAGAS, the auditor should consider whether specialized skills are needed for considering the effect of computerized information systems on the audit, understanding internal control, or designing and performing audit procedures, including tests of internal control. If the use of a professional with specialized skills is planned, the auditor should have sufficient computer-related knowledge to communicate the objectives of the other professional's work; to evaluate whether the specified procedures will meet the auditor's objectives; and to evaluate the results of the procedures applied as they relate to the nature, timing, and extent of other planned audit procedures.

4.21.3 The additional internal control standard for financial statement audits is

In planning the audit, auditors should document in the working papers (1) the basis for assessing control risk at the maximum level for assertions related to material account balances, transaction classes, and disclosure components of financial statements when such assertions are significantly dependent upon computerized information systems, and (2) consideration that the planned audit procedures are designed to achieve audit objectives and to reduce audit risk to an acceptable level.

4.21.4 This additional GAGAS standard does not increase the auditor's responsibility for testing controls, but rather requires that, if the auditor assesses control risk at the maximum level for assertions related to material account balances, transaction classes, and disclosure components of financial statements when such assertions are significantly dependent upon computerized information systems, the auditor should document in the working papers[5.3] the basis for that conclusion by addressing (1) the ineffectiveness of the design and/or operation of the controls, or (2) the reasons why it would be inefficient to test the controls. In such circumstances, GAGAS also require the auditor to document in the working papers the consideration that the planned audit procedures are designed to achieve specific audit objectives and, accordingly, to reduce audit risk to an acceptable level. This documentation should address

a. the rationale for determining the nature, timing, and extent of planned audit procedures;

[5.3]See paragraphs 4.34 through 4.38 for a discussion of the working paper standards.

b. the kinds and competence of available evidential matter produced outside a computerized information system; and

c. the effect on the audit opinion or report if evidential matter to be gathered during the audit does not afford a reasonable basis for the auditor's opinion on the financial statements.

4.22 Safeguarding of assets and compliance with laws and regulations are internal control objectives that are especially important in conducting financial statement audits in accordance with GAGAS of governmental entities or others receiving government funds. Given the public accountability for stewardship of resources, safeguarding of assets permeates control objectives and components as defined by the AICPA standards and GAGAS. Also, the operation of government programs and the related transactions that materially affect the entity's financial statements are generally governed by laws and regulations. Although GAGAS ~~do~~ ***are*** not prescrib~~e~~***ing*** additional internal control standards ***in these areas,*** ~~for financial statement audits. However,~~ this chapter provides ***a discussion*** ~~guidance on the following four aspects of internal controls~~ that ~~are important to the judgments~~ auditors ~~make about~~ ***may find useful in assessing*** audit risk and ~~about the~~ ***in obtaining*** evidence needed to support their opinion on the financial statements~~:~~ ***in a governmental environment.***

~~**a.** control environment,~~

~~**b.** safeguarding controls,~~

~~**c.** controls over compliance with laws and regulations, and~~

~~**d.** control risk assessments.~~

~~Control Environment~~	~~**4.23** Auditors' judgments about the control environment may influence-either positively or negatively—their judgments about specific control procedures. For example, evidence indicating that the control environment is ineffective may lead auditors to question the likely effectiveness of a control procedure for a particular financial statement assertion. Conversely, based on evidence indicating that the control environment is effective, auditors may decide to reduce the number of locations where they will perform auditing procedures.~~ ~~**4.24** Auditors' judgments about the control environment also can be affected by the results of their tests of other internal controls. If auditors obtain evidence that specific control procedures are ineffective, they may find it necessary to reevaluate their earlier conclusion about the control environment and other planning decisions they had made based on that conclusion.~~
Safeguarding ~~Controls~~ ***of Assets***	**4.25** ***As applied to financial statement audits,*** ***i***~~I~~nternal control~~s~~ over safeguarding of assets ~~(safeguarding controls)~~ constitute***s*** a process, effected by an entity's governing body, management, and other personnel, designed to provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

4.26 ***Internal control over the*** ~~S~~*s*afeguarding ~~controls~~ ***of assets*** relate*s* to the prevention or timely detection of unauthorized transactions and unauthorized access to assets that could result in losses that are material to the financial statements~~,~~*;* for example, when unauthorized expenditures or investments are made, unauthorized liabilities are incurred, inventory is stolen, or assets are converted to personal use. Such controls are designed to help ensure ~~that~~ ***the*** use of and access to assets are in accordance with management's authorization. Authorization includes approval of transactions in accordance with ~~policies and procedures~~ ***control activities*** established by management to safeguard assets, such as establishing and complying with requirements for extending and monitoring credit or making investment decisions, and related documentation. ***Control over*** ~~S~~*s*afeguarding ~~controls are~~ ***of assets is*** not designed to protect against loss of assets arising from inefficiency or from management's operating decisions, such as incurring expenditures for equipment or material that proves to be unnecessary or unsatisfactory.

4.27 AICPA standards and GAGAS require auditors to obtain a sufficient understanding of internal control~~s~~ to plan the audit. They also require auditors to plan the audit to provide reasonable assurance of detecting material ~~irregularities~~ ***fraud***, including material misappropriation of assets. Because preventing or detecting material misappropriations is an objective of ***control over*** safeguarding ~~controls~~ ***of assets***, understanding ~~those~~ ***this type of*** control~~s~~ can be essential to planning the audit.

4.28 ***Control over*** ~~S~~*s*afeguarding ~~controls are~~ ***of assets is*** not limited to preventing or detecting misappropriations, however. ~~They~~ ***It*** also help*s* prevent or detect other material losses that could result from unauthorized acquisition, use, or disposition of assets.

Such controls include, for example, the process of assessing the risk of unauthorized acquisition, use, or disposition of assets and establishing control activities to help ensure that management directives to address the risk are carried out. Such control activities would include ~~controls to~~ permit***ting*** acquisition, use, or disposition of assets only in accordance with management's general or specific authorization, including compliance with established ~~policies and procedures~~ ***control activities*** for such acquisition, use, or disposition. They would also include comparing existing assets with the related records at reasonable intervals and taking appropriate action with respect to any differences. Finally, controls over ~~the~~ safeguarding of assets against unauthorized acquisition, use, or disposition also relate to making available to management information it needs to carry out its responsibilities related to prevention or timely detection of such unauthorized activities, as well as mechanisms to enable management to monitor the continued effective operation of such controls.

4.29 Understanding ~~these~~ ***the control over*** safeguarding ~~controls~~ ***of assets*** can help auditors assess the risk that financial statements could be materially misstated. For example, an understanding of an auditee's ~~safeguarding~~ control~~s~~ ***over the safeguarding of assets*** can help auditors recognize risk factors such as

a. failure to adequately monitor decentralized operations;

b. lack of control~~s~~ over activities, such as lack of documentation for major transactions;

c. lack of control~~s~~ over ~~computer processing~~

computerized information systems, such as a lack of ~~controls~~ over access to applications that initiate or control the movement of assets;

d. failure to develop or communicate adequate policies and procedures for security of data or assets, such as allowing unauthorized personnel to have ready access to data or assets; and

e. failure to investigate significant unreconciled differences between reconciliations of a control account and subsidiary records.

~~Controls~~ Over Compliance With Laws and Regulations

4.29.1 Governmental entities are subject to a variety of laws and regulations that affect their financial statements, which is a major factor distinguishing governmental accounting from commercial accounting. For example, such laws and regulations may address the required fund structure, procurement or debt limitations, or authority for transactions. Accordingly, compliance with such laws and regulations may have a direct and material effect on the determination of amounts in the financial statements of governmental entities. Likewise, organizations that receive government assistance, such as contractors, nonprofit organizations, and other nongovernmental organizations are also subject to regulations, contract provisions, or grant agreements that could have a direct and material effect on their financial statements. Management, of both governmental entities and others receiving governmental assistance, is responsible for ensuring that the entity complies with the laws and regulations applicable to its activities. That responsibility encompasses the identification of applicable laws and regulations and the

establishment of controls designed to provide reasonable assurance that the entity complies with those laws and regulations.

4.30 ***AICPA standards and GAGAS require a***~~A~~uditors ~~should~~ ***to*** design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts. To meet that requirement, auditors should have an understanding of internal control~~s~~ relevant to financial statement assertions affected by those laws and regulations. Auditors should use that understanding to identify types of potential misstatements, consider factors that affect the risk of material misstatement, and design substantive tests. For example, the following ~~control environment~~ factors may influence the auditors' assessment of control risk:

a. management's awareness or lack of awareness of applicable laws and regulations,~~;~~

b. auditee policy regarding such matters as acceptable operating practices and codes of conduct,~~;~~ and

c. assignment of responsibility and delegation of authority to deal with such matters as organizational goals and objectives, operating functions, and regulatory requirements.

~~Control Risk Assessments~~

~~4.31~~ ~~When auditors assess control risk below the maximum for a given financial statement assertion, they reduce their need for evidence from substantive tests of that assertion. Auditors are not required to assess control risk below the maximum, but the likelihood that they will find it efficient and effective to do so increases with the size of the entities they audit and the complexity of their operations. Auditors should do the following when assessing control risk below the maximum:~~

~~a.~~ ~~identify internal controls that are relevant to a specific financial statement assertion;~~

~~b. perform tests that provide sufficient evidence that those controls are effective; and~~

~~c.~~ ~~document the tests of controls.~~

~~4.32~~ ~~Auditors should remember the following when planning and performing tests of controls:~~

~~a.~~ ~~The lower the auditors' assessment of control risk, the more evidence they need to support that assessment.~~

~~b.~~ ~~Auditors may have to use a combination of different kinds of tests of controls to get sufficient evidence of a control's effectiveness.~~

~~c.~~ ~~Inquiries alone generally will not support an assessment that control risk is below the maximum.~~

~~d.~~ ~~Observations provide evidence about a control's effectiveness only at the time observed; they do not provide evidence about its effectiveness during the rest of the period under audit.~~

~~**e.** Auditors can use evidence from tests of controls done in prior audits (or at an interim date), but they have to obtain evidence about the nature and extent of significant changes in policies, procedures, and personnel since they last performed those tests.~~

~~**4.33** Auditors may find it necessary to reconsider their assessments of control risk when their substantive tests detect misstatements, especially those that appear to be irregularities or due to illegal acts. As a result, they may find it necessary to modify their planned substantive tests for some or all financial statement assertions. Deficiencies in internal controls that led to those misstatements may be reportable conditions or material weaknesses, which auditors are required to report.~~

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