Section 10

Supplemental Guidance On Internal Control, Abuse, Fraud, and Assessing Significance of Laws, Regulations, Or Provisions Of Contracts Or Grant Agreements

The following sections provide supplemental guidance for auditors and the audited entities to assist in the implementation of generally accepted government auditing standards (GAGAS).

The following are examples of control deficiencies:

a. Insufficient control consciousness within the organization, for example the tone at the top and the control environment. Control deficiencies in other components of internal control could lead the auditor to conclude that weaknesses exist in the control environment.

b. Ineffective oversight by those charged with governance of the entity's financial reporting, performance reporting, or internal control, or an ineffective overall governance structure.

c. Control systems that did not prevent or detect material misstatements so that it was later necessary to restate previously issued financial statements or operational results. Control systems that did not prevent or detect material misstatements in performance or operational results so that it was later necessary to make significant corrections to those results.

d. Control systems that did not prevent or detect material misstatements identified by the auditor. This includes misstatements involving estimation and judgment for which the auditor identifies potential material adjustments and corrections of the recorded amounts.

e. An ineffective internal audit function or risk assessment function at an entity for which such functions are important to the monitoring or risk assessment component of internal control, such as for a very large or highly complex entity.

f. Identification of fraud of any magnitude on the part of senior management.

g. Failure by management or those charged with governance to assess the effect of a significant deficiency previously communicated to them and either to correct it or to conclude that it will not be corrected.

h. Inadequate controls for the safeguarding of assets.

i. Evidence of intentional override of internal control by those in authority to the detriment of the overall objectives of the system.

j. Deficiencies in the design or operation of internal control that could result in violations of laws, regulations, provisions of contracts or grant agreements, fraud, or abuse having a direct and material effect on the financial statements or the audit objective.

k. Inadequate design of information systems general and application controls that prevent the information system from providing complete and accurate information consistent with financial or performance reporting objectives and other current needs.

l. Failure of an application control caused by a deficiency in the design or operation of an information systems general control.

m. Employees or management who lack the qualifications and training to fulfill their assigned functions.

The following are examples of abuse, depending on the facts and circumstances:

a. Creating unneeded overtime.

b. Requesting staff to perform personal errands or work tasks for a supervisor or manager.

c. Misusing the official's position for personal gain (including actions that could be perceived by an objective third party with knowledge of the relevant information as improperly benefiting an official's personal financial interests or those of an immediate or close family member; a general partner; an organization for which the official serves as an officer, director, trustee, or employee; or an organization with which the official is negotiating concerning future employment).

d. Making travel choices that are contrary to existing travel policies or are unnecessarily extravagant or expensive.

e. Making procurement or vendor selections that are contrary to existing policies or are unnecessarily extravagant or expensive.

In some circumstances, conditions such as the following might indicate a heightened risk of fraud:

a. the entity's financial stability, viability, or budget is threatened by economic, programmatic, or entity operating conditions;

b. the nature of the audited entity's operations provide opportunities to engage in fraud;

c. inadequate monitoring by management for compliance with policies, laws, and regulations;

d. the organizational structure is unstable or unnecessarily complex;

e. lack of communication and/or support for ethical standards by management;

f. management has a willingness to accept unusually high levels of risk in making significant decisions;

g. a history of impropriety, such as previous issues with fraud, waste, abuse, or questionable practices, or past audits or investigations with findings of questionable or criminal activity;

h. operating policies and procedures have not been developed or are outdated;

i. key documentation is lacking or does not exist;

j. lack of asset accountability or safeguarding procedures;

k. improper payments;

l. false or misleading information;

m. a pattern of large procurements in any budget line with remaining funds at year end, in order to "use up all of the funds available"; and

n. unusual patterns and trends in contracting, procurement, acquisition, and other activities of the entity or program under audit.

Government programs are subject to many laws, regulations, and provisions of contracts or grant agreements. At the same time, their significance within the context of the audit objectives varies widely, depending on the objectives of the audit. Auditors may find the following approach helpful in assessing whether laws, regulations, or provisions of contracts or grant agreements are significant within the context of the audit objectives:

a. Express each audit objective in terms of questions about specific aspects of the program being audited (that is, purpose and goals, internal control, inputs, program operations, outputs, and outcomes).

b. Identify laws, regulations, and provisions of contracts or grant agreements that directly relate to specific aspects of the program within the context of the audit objectives.

c. Determine if the audit objectives or the auditors' conclusions could be significantly affected if violations of those laws, regulations, or provisions of contracts or grant agreements occurred. If the audit objectives or audit conclusions could be significantly affected, then those laws, regulations, and provisions of contracts or grant agreements are likely to be significant to the audit objectives.

d. Auditors may consult with either their own or management's legal counsel to (1) determine those laws and regulations that are significant to the audit objectives, (2) design tests of compliance with laws and regulations, or (3) evaluate the results of those tests. Auditors also may consult with either their own or management's legal counsel when audit objectives require testing compliance with provisions of contracts or grant agreements. Depending on the circumstances of the audit, auditors may consult with others, such as investigative staff, other audit organizations or government entities that provided professional services to the audited entity, or applicable law enforcement authorities, to obtain information on compliance matters.