1.B Purpose of the FIAR Methodology

The FIAR Methodology defines the key tasks, underlying detailed activities and resulting work products that all reporting entities should follow to become audit ready. The FIAR Methodology maximizes the potential for successful financial statement audits by considering the methods financial statement auditors use to assess financial statement accuracy in accordance with auditing standards. This guidance draws on the definitions, criteria and requirements that financial statement auditors use to help reporting entities adequately prepare for their first-time financial statement audits. This section of the FIAR Guidance focuses on explaining the concepts of financial statement assertions and financial reporting objectives (FROs), and the tests of internal controls and key supporting documents (KSDs) needed to demonstrate audit readiness. Auditors are required to apply professional judgment when determining whether they have obtained sufficient appropriate evidence (through tests of internal controls and key supporting documents) to form an opinion on the financial statements. Reporting entity management must perform a similar assessment to determine whether it has sufficient evidence to demonstrate the organization is audit ready.

Auditing standards codified by the American Institute of Certified Public Accountants (AICPA) define both auditor and management responsibility during a financial statement audit. By engaging an auditor to perform a financial statement audit, reporting entities are required to make an assertion that the financial statements they prepare are complete and accurate. Specifically, "[t]he preparation and fair presentation of the financial statements require management to exercise judgment in making accounting estimates that are reasonable in the circumstances, as well as in selecting and applying appropriate accounting policies. These judgments are made in the context of the applicable financial reporting framework." [AU-C 200.A3]

In rendering an opinion on the financial statements taken as a whole, the auditor is required to assess and test transactions and balances summarized in individual line items reported on the financial statements. To accomplish this, the auditing standards require auditors to evaluate material or significant line items using financial statement assertions. Furthermore, auditors "should design and perform... audit procedures whose nature, timing, and extent are based on, and are responsive to, the assessed risks of material misstatement at the relevant assertion level." [AU-C 330.06] Auditors obtain and draw conclusions from audit evidence on which to base the audit opinion by performing audit procedures to (a) assess risks of material misstatement **at the relevant assertion level**; (b) test the operating effectiveness of **relevant** controls in preventing or detecting material misstatements; and (c) perform substantive tests and procedures for **all relevant assertions** related to each material class of transactions, account balance, and disclosure. [Adapted from AU-C 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*][4]

Auditors generally start by obtaining an understanding of the entity and its controls, assessing risk and analyzing the financial statement line items; then, the individual line items are further broken down to underlying financial statement assertions. While auditors have the discretion to combine or disaggregate financial statement assertions, the five commonly accepted financial statement assertions are existence, completeness, valuation, presentation & disclosure and rights & obligations. **Figure 1-2** demonstrates an example of how the Investments line of the Balance Sheet can be broken down into the five financial statement assertions supporting the one line item. Additional information on these financial statement assertions is included in **Section 3**, *Internal Controls*.

[4] Descriptions of individual financial statement assertions are provided in the FIAR Guidance in Section 5 – Auditing the Financial Statements

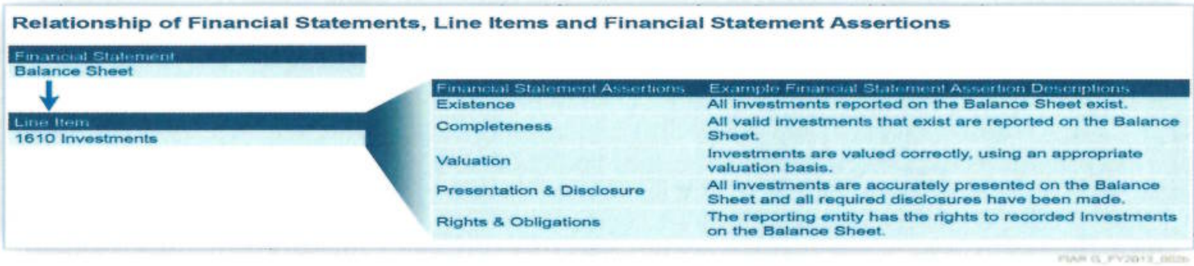


Figure 1-2 Relationship of Financial Statements, Line Items and Financial Statement Assertions

When preparing for audit or examination, reporting entities must fully analyze the financial statement line items included in the scope of its assessable units, identifying all applicable financial statement assertions relative to the line items. The FIAR Methodology defines the specific steps reporting entities must take to perform this analysis (key activities 1.3.1 for internal controls and 1.4.3 for key supporting documents). See section 4.A.3 for a discussion of assessable units.

Relationship of Financial Reporting Objectives to Financial Statement Assertions

Financial Reporting Objectives

The FIAR Directorate compiled a list of FROs mapped to applicable financial statement assertions to assist reporting entities preparing for audit or examination (see Appendix B). FROs are defined as objectives that capture the outcomes needed to achieve proper financial reporting and serve as a point against which the effectiveness of financial controls can be evaluated. In other words, FROs are a further disaggregation of financial statement assertions at the line item level, and are provided in the FIAR Guidance to help reporting entities ensure they have appropriately considered and assessed all relevant risks/assertions.

These FROs were obtained from the Government Accountability Office's (GAO) *Financial Audit Manual* (FAM) and other GAO reports. Utilizing FROs derived from auditor guidance helps reporting entities ensure they have addressed all significant risks and financial statement assertions that will likely be evaluated during financial statement audits.

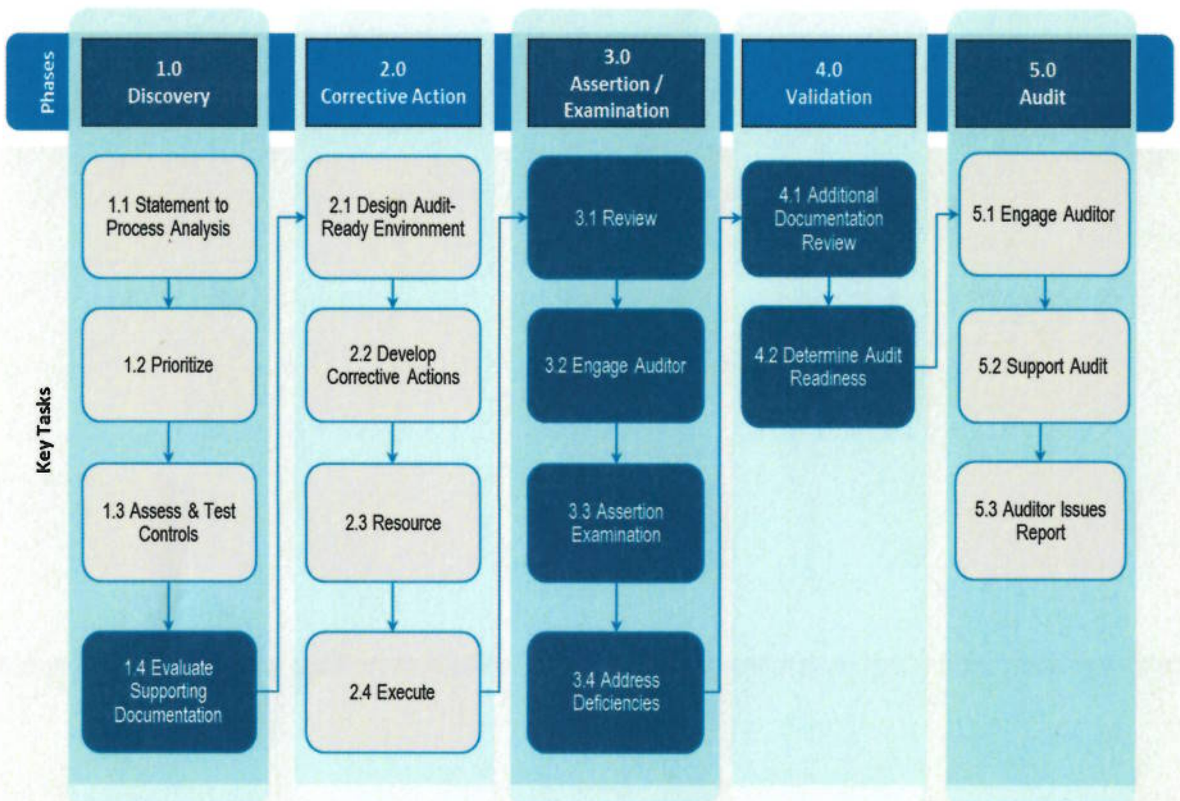
Relationship of Key Supporting Documentation to Financial Reporting Objectives

To succeed in an audit, reporting entities need to demonstrate they have achieved all FROs relevant to an assessable unit. Reporting entities demonstrate achievement of a FRO through internal control and KSD testing. Reporting entities, in accordance with the FIAR Methodology, are required to perform both internal control testing (FIAR Methodology key task 1.3.3) and KSD testing (FIAR Methodology key task 1.4.5). It is through the combination of internal controls testing and key supporting document testing that reporting entities will be able to demonstrate achievement of relevant FROs. Reporting entity management must decide how it will demonstrate audit readiness. The reporting entity must rely on internal controls to some extent, but has flexibility with regard to the extent to which it relies on internal controls to achieve FROs.

In general, areas with large transaction volumes or numerous individual assets (e.g., supply, contracts, Fund Balance with Treasury (FBWT), Inventory, Operating Materiel & Supplies (OM&S), General Equipment (GE), etc.) require management and the auditor to rely more on effective internal controls to provide assurance that balances are properly stated at any given date. Management's determination that effective controls are not in place to mitigate risk for specific FROs does not necessarily preclude an assertion of audit readiness. For example, management may decide that it is more efficient to rely on supporting documentation and limit internal controls reliance for specific FROs for low volume items, such as satellites. However, for populations with a large number of items or with a high volume of transaction activity, such as OM&S, it is more effective and efficient to place more reliance on internal controls, which requires detailed control documentation, including risk assessments, FROs, and internal control assessments. Information technology general controls (ITGCs) and application controls must be designed effectively and

tested for operating effectiveness in order for management to rely on the automated controls and system generated reports (i.e., KSDs). Supporting documentation testing (i.e., substantive testing) cannot overcome ineffective or missing ITGCs and application controls when transaction evidence is electronic and only maintained within a system, or the key supporting evidence is system-generated reports.

Reporting entities should focus their audit readiness efforts on improving their processes, controls, systems and related documentation based on the results of the application of the Methodology. Adherence to the Methodology will also enable the Department to comply with the most relevant laws and regulations that have a direct and material impact on the Department's consolidated financial statements. Any standalone efforts to comply with direct and material laws and regulations affecting the reporting entity's financial statements should be completed after achieving audit readiness. The phases and key tasks of the Methodology can be seen in **Figure 1-3**.



Note: The gray boxes are key tasks that must be repeated on a continuous basis as they are key to achieving and maintaining auditability and reliable financial information.

Figure 1-3. FIAR Methodology Phases and Key Tasks to Achieve Auditability and Reliable Financial Information