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American Institute of Certified Public Accountants. State and Local Government Committee

AICPA
American Institute of Certified Public Accountants

AUDIT AND ACCOUNTING GUIDE

AUDITS OF STATE AND LOCAL GOVERNMENTAL UNITS

PREPARED BY THE STATE AND LOCAL GOVERNMENT COMMITTEE

Revised Edition

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LOCAL GOVERNMENT COMMITTEE

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NOTICE TO READERS

This accounting and audit guide presents recommendations of the AICPA State and Local Government Committee regarding the application of generally accepted auditing standards to audits of financial statements of state and local governmental units. It represents the considered opinion of the committee on the best auditing practice in the industry and has been reviewed by members of the AICPA Auditing Standards Board for consistency with existing auditing standards. AICPA members may have to justify departures from the recommendations contained in this guide if their work is challenged.

This guide also includes descriptions and recommendations regarding specialized accounting and reporting principles and practices for state and local governmental units. The descriptions and recommendations may refer to a GASB or FASB Statement or Interpretation, an APB Opinion, or an AICPA Accounting Research Bulletin. Although this guide does not have the authority of those pronouncements, it is intended to be helpful in determining whether financial statements are in conformity with generally accepted accounting principles. Statement on Auditing Standards No. 5, *The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles" in the Independent Auditor's Report*, as amended by SAS No. 43, *Omnibus Statement on Auditing Standards*, and interpreted by the Auditing Standards Board, *The Auditor's Consideration of Accounting Principles Promulgated by the Governmental Accounting Standards Board*, identifies AICPA guides as sources of established accounting principles that an AICPA member should consider.

This guide is a combination of two draft audit guides that were developed and separately exposed for comment. A general guide was written by the

State and Local Government Committee and a guide dealing with single audits, required under the Single Audit Act of 1984, was written by the Task Force on Single Audits of Federal Financial Assistance.

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Preface

This guide has been prepared to assist the independent auditor in examining and reporting on financial statements of governmental units other than the federal government. Part VII provides guidance to independent auditors providing audits involving federal financial assistance under the requirements of the Single Audit Act of 1984. The guide is intended to be an initial reference source for the independent auditor new to governmental accounting and auditing. It assumes the reader has expertise in accounting and auditing generally, but not in the specialized accounting or auditing practices applicable to state or local governmental units. Accordingly, the discussion of audit procedures concentrates primarily on those unique to governmental audits. The nature, timing, and extent of such auditing procedures are a matter of professional judgment and will vary depending upon the size, organizational structure, existing system of internal accounting control, and other factors in a particular engagement.

The intent of the guide is to discuss existing accounting pronouncements and recognized practices unique to governmental units. It does not advocate answers to unresolved accounting issues, many of which are identified in chapter 20. The auditor should obtain a copy of the Governmental Accounting Standards Board's codification of *Governmental Accounting and Financial Reporting Standards* and any GASB statements issued after the publication date of the codification. Those documents contain the GASB standards established for governmental accounting. If the accounting treatment of a condition, transaction, or other event is not specified in a GASB pronouncement, applicable pronouncements of the Financial Accounting Standards Board should be consulted.

The first edition of the AICPA Industry Audit Guide, *Audits of State and Local Governmental Units*, was published in 1974. Some of the accounting principles specified in that guide have been codified by the GASB. Any modification of those accounting principles will require action by the GASB. This guide supersedes the 1974 guide and related statements of position except for the accounting principles that have been codified.

State and Local Government Committee

January 1986

Part I
Introduction

Chapter 1

Background and Current Status of Governmental Accounting and Auditing

1.1 An increasing number of state and local governments are preparing financial statements in conformity with generally accepted accounting principles (GAAP), and more of those statements are being audited in accordance with generally accepted auditing standards (GAAS). The increased demand for improved financial reporting has resulted in a number of recent significant changes in governmental financial reporting.

1.2 Though research studies have shown that many governments do not present financial statements in conformity with GAAP, a growing number of governments are striving to improve their financial reporting. That is shown by the increasing number of governments submitting their comprehensive annual financial reports (CAFR) to either the Government Finance Officers Association (GFOA) or the Association of School Business Officials (ASBO) to determine if the financial reports meet their standards. A major credit-rating firm has also emphasized the importance of improved governmental financial reporting by publishing a policy statement urging issuers of government debt to prepare financial reports in conformity with GAAP.* In addition, the policy statement recommends audits of financial statements either by a certified public accounting firm or by qualified independent state or local audit agencies. The federal government also has stressed the importance

*"Municipal Governments Warned to Improve Accounting Systems," *Journal of Accountancy,* June 1980 p. 12.

of increased accountability and improved financial reporting and auditing at all levels of government.

1.3 The increased emphasis on improved financial reporting has prompted the National Council on Governmental Accounting (NCGA) and the American Institute of Certified Public Accountants (AICPA) to issue a number of statements, interpretations, and pronouncements on governmental accounting since the mid-1970s. The Governmental Accounting Standards Board (GASB), established in 1984, is now the primary source of GAAP for governments. With its first pronouncement, *Authoritative Status of NCGA Pronouncements and AICPA Industry Audit Guide*, the GASB endorsed prior statements and interpretations of the NCGA. It also has codified that literature in its codification of *Governmental Accounting and Financial Reporting Standards* as of November 1, 1984, and will provide authoritative guidance regarding governmental accounting and financial reporting principles in the future.

GAAP and GAAS for State and Local Governments

1.4 In 1968, the NCGA published *Governmental Accounting, Auditing, and Financial Reporting* (1968 GAAFR). The 1968 GAAFR was generally recognized as an authoritative source of GAAP for state and local governments until it was superseded in 1979 by NCGA Statement 1, a restatement of 1968 GAAFR principles. The NCGA subsequently issued additional statements and interpretations expanding on the basic principles established in Statement 1. The 1968 GAAFR is no longer considered authoritative. The GFOA published a 1980 GAAFR that also is not considered authoritative.

1.5 Before the publication of this guide, the preceding AICPA Industry Audit Guide, *Audits of State and Local Governmental Units* (the 1974 guide), published in 1974 and later amended, was also a major source of GAAP and GAAS for governments. The following AICPA Statements of Position (SOPs) amended the 1974 guide:

- 75-3, *Accrual of Revenues and Expenditures by State and Local Governmental Units*
- 77-2, *Accounting for Interfund Transfers of State and Local Governmental Units*

- 78-7, *Financial Accounting and Reporting by Hospitals Operated by a Governmental Unit*
- 80-2, *Accounting and Financial Reporting by Governmental Units*

The 1974 guide and the above SOPs are being superseded by this guide. (See preface regarding certain accounting principles not being superseded.)

Sources and Status of GAAP

National Council on Governmental Accounting

1.6 The NCGA has issued the following statements and interpretations:

- Statement 1, *Governmental Accounting and Financial Reporting Principles*, issued in 1979 and effective for years ending after June 30, 1980. It supersedes and restates the principles of 1968 GAAFR and supersedes Interpretation 1. It also incorporates SOPs 75-3 and 77-2. The authoritative status of Statement 1 was recognized by the AICPA in SOP 80-2.
- Statement 2, *Grant, Entitlement, and Shared Revenue Accounting and Reporting by State and Local Governments*, issued in 1979 and effective for years ending after June 30, 1980. It clarifies the principles of Statement 1 as they apply to intergovernmental grant, entitlement, and shared revenue accounting and financial reporting.
- Statement 3, *Defining the Governmental Reporting Entity*, issued in 1982 and effective for years ending after December 31, 1982. It provides criteria for defining the organizations, functions, and activities that should be considered within a government's reporting entity.
- Statement 4, *Accounting and Financial Reporting for Claims and Judgments and Compensated Absences*, issued in 1982 and effective for years beginning after December 31, 1982. It establishes accounting and reporting requirements for claims and judgments and compensated absences.
- Statement 5, *Accounting and Financial Reporting Principles for Lease Agreements of State and Local Governments*, issued in 1982 and effective for years beginning after June 30, 1983. It provides guidance on accounting and financial reporting for lease agreements.

- Statement 6, *Pension Accounting and Financial Reporting: Public Employee Retirement Systems and State and Local Government Employers*, issued in 1983, but its effective date was deferred indefinitely. It establishes accounting and reporting requirements for defined benefit pension systems and pension accounting for state and local government employers.
- Statement 7, *Financial Reporting for Component Units Within the Governmental Reporting Entity*, issued in 1984, provides guidance on the application of NCGA Statement 3.
- Interpretation No. 1, *GAAFR and the AICPA Audit Guide*, was issued in 1976 and was superseded by Statement 1.
- Interpretation No. 2, *Segment Information for Enterprise Funds*, issued in 1980 and effective for years ending after September 30, 1980.
- Interpretation No. 3, *Revenue Recognition—Property Taxes*, issued in 1981 and effective for years beginning after September 30, 1981.
- Interpretation No. 4, *Accounting and Financial Reporting for Public Employee Retirement Systems and Pension Trust Funds*, issued in 1982. This interpretation was repealed effective June 30, 1983.
- Interpretation No. 5, *Authoritative Status of Governmental Accounting, Auditing and Financial Reporting (1968)*, issued in 1982 and effective immediately.
- Interpretation No. 6, *Notes to the Financial Statements Disclosure*, issued in 1982 and effective for years beginning after December 31, 1982.
- Interpretation No. 7, *Clarification as to Application of the Criteria in NCGA Statement 3 Defining the Governmental Reporting Entity*, issued in 1983 and effective immediately.
- Interpretation No. 8, *Certain Pension Matters*, issued in 1983 and effective for years ending after December 31, 1983.
- Interpretation No. 9, *Certain Fund Classifications and Balance Sheet Accounts*, issued in 1984 and effective for years beginning after June 30, 1984.
- Interpretation No. 10, *Budgetary Reporting*, issued in 1984 and effective for years ending after June 30, 1984.
- Interpretation No. 11, *Claims and Judgment Transactions for*

Governmental Funds, issued in 1984 and effective immediately.

The above pronouncements are included in the GASB's codification of *Governmental Accounting and Financial Reporting Standards* as of November 1, 1984.

Financial Accounting Standards Board

1.7 Applicable Financial Accounting Standards Board (FASB) statements and interpretations are another source of GAAP for governments. GASB pronouncements take precedence over FASB pronouncements with regard to state and local governmental entities, but if the accounting treatment of a transaction or event is not specified in a GASB pronouncement, and the FASB has dealt with the subject, the FASB pronouncement is presumed to apply. That presumption includes, to the extent they have not been superseded, Accounting Principles Board Opinions and Accounting Research Bulletins.

Governmental Accounting Standards Board

1.8 The most recent step directed towards building a structure for accounting and financial reporting standard setting for governments is the establishment of the GASB. GASB pronouncements are applicable to the financial statements of governmental units and, as discussed in the auditing interpretation, "The Auditor's Consideration of Accounting Principles Promulgated by the Governmental Accounting Standards Board," (AICPA, *Professional Standards*, Vol. 1, AU sec. 9411.05–.10), constitute the primary source of GAAP for governmental units.

State Government Accounting

1.9 Additionally, though having no official status and conflicting in some respects with current GAAP, financial accounting and reporting guidance for states is provided by *Preferred Accounting Practices for State Governments* (PAPSG), a research report issued in 1983 by the Council of State Governments and NCGA. PAPSG is based in part on an extensive survey of state accounting and financial reporting practices. It represents the consensus views of the Project Committee, consisting of state financial officials and representatives of a number of public accounting firms. In developing the views, the Project Committee also considered comments from individuals and organizations on a series of issues papers published in 1980.

Sources and Status of Audit Standards and Requirements

AICPA

1.10 AICPA Statements on Auditing Standards (SASs) and related interpretations apply to the audits of financial statements of governments, except to the extent the underlying subject matter is not present in such financial statements.

States

1.11 Some state agencies have prescribed accounting systems, financial reports, and audit guidelines and standards relating to governmental units within their jurisdiction. Accounting, reporting, and auditing guidelines and regulations established by states do not supersede GAAP or GAAS; rather, a governmental unit and its auditor should generally comply with both. Usually, that involves issuing financial statements on alternative bases of accounting or in differing formats to comply with the separate requirements.

Federal

1.12 In 1972, the Comptroller General of the United States issued *Standards for Audit of Governmental Organizations, Programs, Activities and Functions* (Standards for Audit issued by the GAO (U.S. General Accounting Office)). Those standards were revised and reissued in 1981. In 1973, the AICPA published a report entitled *Auditing Standards Established by the GAO—Their Meaning and Significance for CPAs*, which provided interpretive guidance for the 1972 publication. Attachment P to Circular A-102, issued by the U.S. Office of Management and Budget (OMB) in October 1979, established the *single audit* concept for federal grant programs. The single audit concept was incorporated in federal law in the Single Audit Act passed by Congress in October 1984. On April 12, 1985, the OMB issued Circular No. A-128, *Audits of State and Local Governments*, which superseded Attachment P to Circular A-102. The Circular was issued pursuant to the Single Audit Act of 1984 and established audit requirements for state and local governments that receive federal aid.

1.13 Those audit and reporting standards included in the 1981 Standards for Audit issued by the GAO that relate to financial and compliance audits, though embracing all existing AICPA financial audit standards, refer to a number of additional auditing and reporting standards. Those additional standards relate principally to the requirement to (a) perform reviews and tests for compliance with laws and regulations and include in a required compliance report positive assurance on items tested and certain other compliance reporting requirements, (b) submit a more detailed report on the study and evaluation of internal accounting controls than is currently required by AICPA standards, and (c) state that the examination was performed in accordance with the Standards for Audit issued by the GAO. Independent accountants who agree to perform a financial and compliance examination in accordance with those standards should read and become familiar with their more detailed provisions.

1.14 The GAO, the OMB, and other federal agencies have issued various audit guides and circulars and other publications that contain important guidance for audits of specific federal assistance programs. If applicable, the auditor should become knowledgeable with respect to their provisions.

1.15 In 1982, the Auditing Standards Division of the AICPA issued an interpretation of SAS No. 22, *Planning and Supervision*, entitled "Planning Considerations of an Audit of a Federally Assisted Program," which discusses working papers and documentation requirements. An interpretation of SAS No. 30, *Reports on Internal Accounting Control*, entitled "Report Required by U.S. General Accounting Office," was also issued in 1982 and provides guidance on reporting on internal accounting controls required by Standards for Audit issued by the GAO. Other interpretations have been issued that should be considered in applicable circumstances.

Expanded Scope Audits

1.16 The primary objectives of a financial and compliance audit are to express an opinion on the fairness of the financial statements in conformity with GAAP and to determine whether the governmental unit has complied with applicable legal requirements in obtaining and expending public monies. In contrast, *expanded scope auditing*, as defined in the 1981 Standards for Audit issued by the GAO, requires determining whether the governmental unit (a) is achieving desired results or benefits, (b) is meeting the objectives established by the legislative or other authorizing body, and (c) has considered alternatives that might yield the desired results at lower cost. In essence, expanded scope auditing requires determining whether the governmental unit is operating with economy and efficiency as well as effectiveness.

1.17 Guidance for such audits is beyond the scope of this guide. The following AICPA documents provide guidance in performing an expanded scope audit:

- *Auditing Standards Established by the GAO—Their Meaning and Significance for CPAs* (1973)
- *Guidelines for CPA Participation in Government Audit Engagements to Evaluate Economy, Efficiency, and Program Results MAS Guideline Series No. 6* (1977)
- *Operational Audit Engagements* (1982)

The Role of This Guide

1.18 This guide deals primarily with auditing, including various aspects of auditing elements of financial statements. Further, it distinguishes financial and compliance audits from expanded scope audits and describes the auditor's reporting standards. The guide also discusses GAAS, particularly relevant AICPA SASs, and selected federal government publications. It also discusses generally accepted government auditing standards as that unique term is used by the GAO. Illustrative auditors' reports are provided in an appendix to the guide.

1.19 This guide discusses existing accounting literature and practice. It does not establish any new principles or eliminate existing alternatives. The auditor should determine what pronouncements have been issued by the GASB, the FASB, and the Auditing Standards Board subsequent to the publication of this guide.

Chapter 2

The Governmental Entity and Fund Structure

Entity

2.1 Before NCGA Statement 3, *Defining the Governmental Reporting Entity* (GASB Cod. sec. 2100), was issued, little guidance had been provided as to the nature of operations that should be included in the general purpose financial statements of a government. That caused diversity in the manner in which component units of governments were aggregated in financial statement presentations. Significant activities controlled by the reporting entity were frequently excluded from the entity's general purpose financial statements.

2.2 The purpose behind the omission of component units from a reporting entity's general purpose financial statements may sometimes have been to avoid reporting large amounts of debt incurred by the excluded components; more frequently, the components were excluded simply because their operations were viewed as independent of the governmental unit being reported on. Further, governments often create single-purpose, self-supporting component units that do not require direct financial investments, in contrast with the way investor and investee relationships are usually established in the private sector. Parent or affiliated relationships are therefore often less clearly defined in governments. The NCGA promulgated Statement 3 to—

- Improve comparability among the financial statements of units of government.
- Reduce the possibility of arbitrary exclusion or inclusion of organi-

zational elements and thereby establish reporting comprehensiveness.
- Establish consistency between financial reporting and management responsibility to control operations.

2.3 To meet its objectives, the NCGA identified several criteria, called *manifestations of oversight*, considered useful in determining whether the financial results of a governmental unit should be reported on separately or included in the general purpose financial statements of another level of government. Those criteria include the following:

- Financial interdependency
- Selection of governing authority
- Designation of management
- Ability to significantly influence operations
- Accountability for fiscal matters
  - Budgetary authority
  - Surplus and deficits
  - Fiscal management
  - Revenue characteristics
- Scope of public service
- Financing relationships

2.4 Each of those criteria is described in GASB Cod. sec. 2100. They are expected to provide significant guidance to managements and independent auditors concerning the inclusion or exclusion of components from the government's general purpose financial statements. Judgment must nevertheless be applied in each circumstance. GASB Cod. sec. 2600 discusses related presentation and disclosure matters.

Fund Structure

2.5 The chapters of this guide have been organized to present discussions principally by fund category: governmental (chapters 6 through 12), proprietary (chapter 13), and fiduciary (chapter 14). This chapter discusses the various types of funds and account groups in which transactions are recorded and reported in a governmental entity. Fund accounting and the fund structure are discussed more comprehensively in the texts listed in the bibliography. Funds can be classified as governmental, proprietary, and fiduciary funds.

2.6 Governmental funds are used principally to account for the ongoing activities of government that are financed with general government revenues in the form of taxes, license fees, grants, and entitlements. They are also used to record the acquisition of general governmental assets, such as streets and city hall. These funds are accounted for on the modified accrual basis of accounting and some costs, including depreciation, ordinarily are not allocated among accounting periods. Instead, the funds generally account for the flow of resources (revenues and expenditures) into and out of the funds.

2.7 The activities of proprietary funds closely resemble those of ongoing businesses in which the purpose is to conserve and add to basic resources while meeting operating expenses from current revenues. Their activities are usually financed with user charges that are directly related to the services received. The intent of the proprietary activity usually is to recover the cost of operations. However, it is permissible to account for business-type activities within a proprietary fund when the purpose is only to provide an improved level of management control over costs incurred, for example, when the government chooses to finance the majority of a utility operation from general revenues. Proprietary fund financial statements therefore report allocated costs, such as depreciation and other operating expenses. They apply accrual accounting principles appropriate for business enterprises.

2.8 Fiduciary funds are used to account for activities of a governmental unit in which it is acting as a trustee or agent for individuals or other governments. The method of accounting depends on the nature of the fiduciary responsibility. Fiduciary accounting may be accrual or modified accrual.

2.9 The broad categories of funds are further classified by types.

Governmental Funds

2.10 *General Fund.* The general fund accounts for all activities except those required to be accounted for in another fund. Revenues in this fund are derived from taxes, fees, and other sources that usually are not designated for any specific purposes (for example, licenses, permits, or charges for incidental services). The revenues are used for general ongoing government services such as administration, maintenance, and police and fire protection.

2.11 *Special Revenue Funds.* Special revenue funds generally account for the expenditure of revenues that have been restricted to specific programs or projects (including expenditures for major facility purchases classified as capital projects), for example, a special tax levy assessed for the purpose of promoting recreational programs.

2.12 *Capital Projects Funds.* Capital projects funds account for the receipt and disbursement of resources for the purpose of building or buying major capital assets, such as schools, public buildings, or recreational facilities. Resources may be derived from a variety of sources, including bond proceeds, loans, or grants.

2.13 *Debt Service Funds.* Debt service funds account for resources set aside to pay interest and principal on long-term debt.

2.14 *Special Assessment Funds.* Special assessment funds account for revenues and expenditures related to improvements, maintenance, or repairs to public property for which assessments are levied against the property owners who are expected to benefit directly from the services or improvements. For example, a special assessment for installing sidewalks is usually levied against the property owners along whose property the walks are installed.

Proprietary Funds

2.15 *Enterprise Funds.* Enterprise funds account for activities that are usually self-sustaining, principally through user charges for services rendered, for example, the operation of water supply and sewerage plants, hospitals, or transportation systems. They are also used when management desires to control or measure costs of service, for example, of a public transportation system.

2.16 *Internal Service Funds.* Internal service funds account for services performed by one government organization or department for others, for example, maintenance and repair of vehicles by a centralized garage or operation of a centralized data processing center.

Fiduciary Funds

2.17 *Trust and Agency Funds.* Trust and agency funds account for collection and disbursement of assets held in trust or as an agent by a government for an individual, a group of individuals, or another governmental unit. Typical examples of trust and agency funds are a pension fund that the government administers on behalf of its employees, a fund from which the government awards scholarships to specified individuals in accordance with the terms of a scholarship trust agreement entered into with the donor, and a fund collecting and holding property taxes on behalf of another government.

Number of Funds

2.18 A governmental unit should maintain only one general fund and may establish any number of special revenue, capital project, special assessment, debt service, enterprise, internal service, and trust and agency funds to account for its separate projects and activities. However, for financial reporting purposes, GASB Cod. sec. 1900.110 and 2200.103 require the combining of similar fund-type activities (for example, all special revenue funds) in general purpose financial statements. The use of separate funds should be limited to those cases in which they are required by law or in which they are considered essential to maintaining financial management control.

Account Groups

2.19 In addition to the previously described funds, governments also maintain separate accountability for general government fixed assets and long-term liabilities, known technically as account groups.

2.20 In accounting for governmental funds, fixed asset acquisitions are recorded as expenditures, and borrowings are recorded as sources of resources. Accordingly, as further described in chapter 9, the accounting procedure of recording fixed assets and long-term liabilities in the governmental fund balance sheet is not practiced. However, to facilitate maintaining accountability, those transactions are recorded in the account groups known as the "general fixed assets account group" and the "general long-term debt account group." Fixed assets and long-term debt are recorded in those account groups by means of contra-accounts in the account group balance sheets. The contra-account for fixed assets is an equity account called "investment in fixed assets." The contra-accounts to long-term liabilities are called "amount to be provided for retirement of general long-term liabilities" and "amount available in debt service fund." Account groups do not have operations and thus an operating statement is not prepared. However, a summary of account group changes should be presented in statement or note form.

Chapter 3

Internal Controls

3.1 In response to perceived public sector abuses, Congress passed legislation creating offices of the inspector general in major federal government agencies and departments. The legislation was intended to increase the emphasis on prevention and detection of fraud, waste, and abuse in the federal government by improving internal control systems. Interest in deterring abuses in government through the improvement of internal control systems has continued to increase since 1978. A continuing flow of federal legislation and regulation has evolved, affecting not only federal government activities, but also increasing expectations of state and local government accounting and internal control systems. Some state and local governments have undertaken similar initiatives.

3.2 Audits of governmental entities also increased substantially during that same period. Consequently, knowledge and awareness of the characteristics, strengths, and weaknesses associated with government internal control systems have increased. This chapter discusses those insights, which should provide a better basis for evaluating the implications of internal control systems on examinations of financial statements of governmental entities.

Public Reaction

3.3 Public desire for reducing taxes and for more effective and economical use of resources since the mid-1970s is evident in actions such as Proposition 13 in California, which established a sharply reduced limit on property taxes. Such citizen-sponsored initiatives require governments to do more with less. That environment requires governments to improve accounting and administrative controls for increased public accountability and more effective use of resources.

3.4 At the federal level, the inspector general legislation, OMB Circular A-123, and the Federal Managers' Financial Integrity Act of 1982 emphasize the need to improve internal controls in government. That act required the OMB to issue guidelines for federal agencies to follow in their required annual assessments of and reporting on internal controls. The act also required the GAO to issue internal control standards or the criteria against which federal agencies are to assess and report on their controls.

3.5 Those legislative and administrative initiatives are important to state and local governments because they establish the tone of federal government expectations and provide a model for state and local governments.

3.6 Recent pressures on governments to adopt GAAP and initiate audits in accordance with GAAS also have as a primary objective improving the internal control environment and accountability of all levels of government.

3.7 The public indirectly influences the internal control system in ways other than increased demands for greater accountability. The presence of active public interest groups in the day-to-day affairs of governments creates an internal control consciousness. In addition, the close scrutiny by the press of governmental operations and the recent initiation of fraud hot lines add further internal control dimensions.

General Control Considerations

3.8 The auditor has historically focused attention on internal accounting control rather than on administrative control, because internal accounting control is within the scope of the study and evaluation of internal control contemplated by GAAS, while administrative control is not. Auditors have generally considered administrative controls to be more directly related to operational efficiency and effectiveness. Accordingly, administrative controls have not been a primary concern to the auditor unless the terms of an engagement are specifically directed toward them, which would be the case when conducting single audits.

3.9 Standards for Audit issued by the GAO reinforces the distinction between accounting and administrative controls by identifying three distinct types of audits of governmental entities: (1)

financial and compliance, (2) economy and efficiency, and (3) program results. Though the GAO recognizes those distinctions, legislation and government regulations more frequently describe auditor's responsibility related to internal controls generally without distinguishing between accounting and administrative controls. Therefore, the auditor who accepts a governmental engagement that includes a study and evaluation of internal controls should obtain clear agreement on the type of controls to be studied and evaluated.

3.10 The recent change in focus of government grant auditing, from the audit of individual grant activity to a "single audit" approach, requires that increased attention be devoted to both internal accounting control systems and administrative control systems. Part VII discusses those requirements of the Single Audit Act that relate to the study and evaluation of internal control systems used in administering federal financial assistance.

3.11 Many individuals and organizations are concerned with a governmental organization's internal control systems, including management, internal auditors, grantor agencies, and independent auditors. Auditors can gain better insight into how those groups attempt to influence examinations of financial statements if they understand the objectives of those groups.

Management

3.12 The administration of a governmental entity has executive, judicial, and legislative components. The executive branch of a government is responsible for instituting and maintaining a satisfactory control environment for operations. Though the executive branch is often prompted by legislative action, some executives consider such action as interference in the management process. Congressional passage of the Federal Managers' Financial Integrity Act of 1982 is an example of action taken by a legislature when it considered the executive branch to be reacting too slowly to concerns about internal control systems. The act imposes stringent internal control reporting requirements on the executive branch of the federal government.

3.13 Management's awareness and attitude toward internal controls affect the control environment that the auditor should evaluate early in an audit engagement. Management should understand its responsibilities to implement and maintain adequate internal control systems and should be capable of—

- Initiating procedures to detect areas of operation particularly vulnerable to fraud and misuse of assets or circumstances that may adversely affect the reliability of the government's financial statements.
- Establishing procedures to monitor and evaluate compliance with internal control systems.
- Instituting timely action to correct identified internal control system weaknesses.

3.14 Management's perception of its responsibilities for the internal control environment can significantly affect the conduct of an audit and the development of a professional relationship between the independent auditor and management.

Internal Auditors

3.15 As in a commercial entity, internal auditors of governments usually play a significant role in monitoring internal control systems and making recommendations for improvement. The internal audit organization usually attempts to maintain its independence from and responsiveness to both the executive and the legislative branches, though it may report administratively to either branch.

3.16 In some governments, auditors are elected rather than appointed. Publicly elected governmental auditors are usually considered independent of both the executive and legislative branches of government and thus do not fall within the traditional definition of internal auditors. However, determining the independence of the governmental auditor becomes more complex at the state and federal level. Many state legislatures have appointed legislative auditors whose purpose is to perform independent financial, compliance, and operational audits of governmental programs administered by executive branch agencies. The GAO serves the Congress in such a capacity at the federal level.

3.17 The executive branches of state and federal governments frequently establish internal audit organizations within each operating department. Such a departmental internal audit organization is normally responsible for (a) internal audit of departmental activity and (b) audit of grantees (beneficiaries) to whom the department provides funds in accordance with legislative programs. Present legislation creating inspectors general combined federal departmental audit and investigation staffs into what is believed to be a more effective force to combat fraud, waste, and abuse in the federal government.

3.18 The presence of an internal audit function may affect an organization's internal control systems in two ways. First, the presence of an internal audit function usually increases the attention devoted to internal controls of the organization. Second, to the extent an internal audit function is responsible for a continuing evaluation of internal control systems, it serves an important role by monitoring the control systems.

3.19 The auditor should recognize the variety of roles and perspectives internal audit functions may have within government and the effects on the organization's internal control system. SAS No. 9, *The Effect of an Internal Audit Function on the Scope of the Independent Auditor's Examination*, discusses the effects of internal audit organizations on the independent auditor's examination.

Grantor Agencies

3.20 Organizations outside the governmental entity being examined also may have an effect on control systems. A significant portion of a local government's revenues may be derived from either federal or state programs. The terms of the grant or entitlement agreements frequently impose considerable control requirements on the recipient. Grant provisions may relate not only to how funds are used, but also to accounting, reporting, and control system requirements.

3.21 Grantor agencies naturally are concerned with the quality of internal control systems established by grantees to assure compliance with grant terms and conditions. The independent auditor is also concerned because the scope of an audit may be affected by the quality of existing internal control systems. Failure to comply with the terms of grant agreements may give rise to contingent liabilities and thus is a factor in expressing an opinion on the financial statements of the grantee.

3.22 The current trend away from specific purpose (categorical) grant programs toward a broader, more discretionary (block) approach to grants, together with implementation of the single audit approach to grant auditing, has significantly increased interest in grantee internal control systems. Those matters are discussed further in chapters 5 and 17.

Independent Auditors

3.23 GAAS require the independent auditor to study and evaluate internal accounting control systems for the purpose of determining the basis of reliance thereon and the extent to which substantive tests may be limited. They do not, however, require a comprehensive evaluation of each phase of a system. The auditor is referred to SAS No. 1, section 320, as amended by SAS No. 43, *Omnibus Statement on Auditing Standards*, and SAS No. 48, *The Effects of Computer Processing on the Examination of Financial Statements*, for further guidance. In general, the more reliance the auditor places on the internal accounting control system based on the study and evaluation of that system, the less substantive audit testing is required.

3.24 As recognized by the Standards for Audit issued by the GAO, there are at least three reasons why the auditor might not make a detailed study and evaluation of internal accounting controls.

(a) The entity is so small that it is not feasible to have an adequate internal control system.

(b) The auditor may conclude that the audit can be performed more efficiently by not limiting substantive audit tests, thus placing very little reliance on the internal control system.

(c) The existing internal control system may contain so many weaknesses that the auditor has no choice but to rely on substantive testing, thus virtually ignoring the internal control system.

3.25 In most circumstances, the auditor places some degree of reliance on internal accounting controls and is able to limit the extent of substantive audit testing. Individual circumstances will indicate the extent of reliance and the amount of testing necessary.

3.26 In accordance with SAS No. 20, *Required Communication of Material Weaknesses in Internal Accounting Control*, an auditor is required to communicate material weaknesses in internal accounting controls noted during an audit. SAS No. 30, *Reporting on Internal Accounting Control*, deals with reporting on internal accounting controls in such circumstances and also with separate studies and evaluations made for the purpose of expressing opinions on internal accounting controls. However, the auditor, when performing audits pursuant to the Standards for Audit issued by the GAO, should look to the interpretation of SAS No. 30 (AICPA, *Professional Standards*, vol. 1, AU sec. 9642.18-.25 and .35-.38) for guidance in preparing a report as well as chapter 23 and Appendix A, example 19.

3.27 In addition to noting weaknesses in internal accounting controls, the auditor may, in the performance of an audit, identify a number of opportunities for improving operations. Governmental organizations are usually receptive to such comments and suggestions and often require a communication of such observations annually. Such suggestions can be included in the report on internal accounting controls or may be the subject of a separate communication with management.

3.28 Finally, because management and internal control reports issued to governments are often publicized, the executive and legislative members of the government are usually sensitive to the auditors' observations and the manner in which they are expressed.

Audit Considerations

3.29 Government operations include a number of characteristics and systems different from those in the private sector that may significantly affect the control environment, such as the following:

- Budget and appropriation systems
- Obligation and encumbrance systems
- Personnel control systems
- Procurement systems

Budget and Appropriation Systems

3.30 The budget and appropriation process of governments often provides substantial control over expenditures. Public budget hearings permit the press and public interest groups to influence expected levels of expenditures. Once adopted, the budget becomes the authorization for operations. Depending on the degree and level of budgetary control, the executive branch may be allowed little discretion over program spending.

Obligation and Encumbrance Systems

3.31 Many government budgetary control systems (encumbrance systems) have as their goal two primary objectives: (a) to determine that the proposed expenditures are allowed by the budget and (b) to make sure that the proposed expenditures do not exceed budgeted amounts. Encumbrances or commitments are frequently recorded in the accounting system. Recording encumbrances or commitments at the time of commitment rather than when the goods or services are received provides an additional level of control.

Personnel Control Systems

3.32 Within most units of government, the procedures required to add or delete personnel from the organization's payroll are usually well established. Complex civil service regulations, designed to provide equity in job assignments, job protection, and other security to employees, require the implementation of specific controls. When coupled with budgetary control they reduce opportunities for discretionary hiring and termination. However, unless the control system requirements are executed properly and are linked to performance monitoring, they will not achieve their objectives. Moreover, special units of government, such as public authorities, often are not under the same stringent controls.

Procurement Systems

3.33 Procurement techniques and the types of contracts and agreements used to acquire goods and services in governments parallel those of the private sector. However, regulations surrounding the administration and use of those procedures by governments usually permit far less latitude and discretion than commonly exists in the private sector. Because governmental procurement procedures usually provide for (a) public notice of procurement opportunities, (b) disclosure of procurement evaluation procedures, and (c) bidding procedures, significant procurements in government are usually exposed to a high level of public scrutiny.

3.34 Each of those characteristics may enhance the internal control systems in government. However, if the systems are not operating as prescribed, weaknesses may exist. Broadly drawn budgets do not constrain unwarranted executive options, and transactions approved in a perfunctory manner may undermine internal controls. Accordingly, before relying on those controls, the auditor should obtain assurance that the systems are operating as intended.

Auditing Pronouncements

3.35 A number of publications discuss the need for controls and evaluations of controls.

Federal Government

3.36 Standards for Audit issued by the GAO, when applicable, requires expanded disclosures in auditors' reports on studies and evaluations of internal control systems.

3.37 The Single Audit Act of 1984, discussed further in chapter 17 and part VII, requires certain state and local governments to adopt the "single audit" approach to grant auditing and requires the evaluation of the grantee's internal control systems.

American Institute of Certified Public Accountants

3.38 The following AICPA auditing standards and interpretations provide further guidance in performing a study and evaluation of internal controls.

• SAS No. 1, *The Auditor's Study and Evaluation of Internal Control*	AU sec. 320
• SAS No. 9, *The Effect of an Internal Audit Function on the Scope of the Independent Auditor's Examination*	AU sec. 322
• SAS No. 16, *The Independent Auditor's Responsibility for the Detection of Errors and Irregularities*	AU sec. 327
• SAS No. 20, *Required Communication of Material Weaknesses in Internal Accounting Control*	AU sec. 323
• SAS No. 30, *Reporting on Internal Accounting Control*	AU sec. 642
• SAS No. 43, *Omnibus Statement on Auditing Standards*	AU sec. 320
• SAS No. 48, *The Effects of Computer Processing on the Examination of Financial Statements*	AU sec. 320
• *Reporting on Internal Accounting Control: Auditing Interpretations of AU Section 642*	AU sec. 9642

3.39 The chapters that follow and Appendix B provide guidance on studying and evaluating internal controls for the specific operating and transaction systems of governments.

Chapter 4

Tests of Compliance With Laws and Regulations

4.1 In a nongovernmental setting, the term compliance testing usually refers to testing for compliance with internal accounting control procedures. Though such tests are also appropriate in a governmental environment, references to compliance testing also include tests performed to determine whether the government is complying with the provisions of laws, regulations, and contractual grant, loan, and other assistance agreements. The objectives of tests of compliance with laws and regulations are to determine whether there have been events of noncompliance that may have a material effect on the financial statements or to provide a basis of reporting on the government's compliance with such laws and regulations. Accordingly, tests of compliance with laws and regulations are substantive tests usually accomplished by examining supporting documentation. In determining the extent of substantive tests of compliance with laws and regulations that are required, the auditor may choose to rely on the internal controls designed to ensure compliance in order to reduce the extent of substantive testing.

The Compliance Perspective

4.2 The absence of a direct relationship between expenditures and revenue and other disciplines imposed in a for-profit environment often causes governments to institute laws, ordinances, and procedures to control their operations. Additionally, states and local governments establish restrictions on their operations because they see a need to —

- Limit the powers of elected officials.

- Safeguard the resources of the public.
- Assure consistency in annual financial reporting of constituent governments.
- Assure that operations are conducted in accordance with the intent of legislated programs.
- Limit the opportunity for undue political influence on governmental operations.
- Assure that public issues are aired through public hearings.
- Impose operating restrictions on the executive branch.
- Assure that the activities of similar governmental units are executed consistently.

Accordingly, the independent auditor becomes familiar with the laws, regulations, and other forms of compliance requirements of a state or local government and the manner in which they influence the government's financial operations. The independent auditor should also recognize that many areas of compliance expected to be reviewed cannot be quantified in terms of dollars, frequently making customary measures of materiality inapplicable.

4.3 As a further complication, some compliance requirements (for example, state laws) may mandate financial reporting on a basis other than GAAP, for example, cash basis reporting. GASB Cod. sec. 1200.112 clearly establishes that for reporting purposes, GAAP are not affected by accounting requirements that may be specified in law or regulations. GASB Cod. sec. 1200.113 provides the following guidance related to compliance with accounting and financial reporting laws and regulations:

> Where financial statements prepared in conformity with GAAP do not demonstrate finance-related legal and contractual compliance, the governmental unit should present such additional schedules and narrative explanations . . . as may be necessary to report its legal compliance responsibilities and accountabilities. In extreme cases, preparation of a separate legal basis special report may be necessary.

4.4 In private sector auditing, most of the auditor's attention in reviewing finance-related legal and contractual compliance is focused on debt and equity agreements and covenants. Most governmental clients and senior levels of government exercising some degree of oversight significantly rely on the independent auditor to review and report on a wide spectrum of possible compliance areas. Reports are often required to be made to the organization's executive and legislative branches and sometimes directly to senior governments. Accordingly, an independent auditor should consider the compliance reporting expectations of management and senior governments in addition to determining the extent of compliance testing necessary to evaluate the accounting and disclosure in the entity's financial statements. That task requires the exercise of judgment and often cannot be confined to areas of material financial statement significance.

4.5 Standards for Audit issued by the GAO refers to an auditor's examination of the financial activities of a governmental entity as a financial and compliance examination. The separate reference to compliance suggests that the reporting of compliance violations may not in all cases be limited to matters in terms of their effect on the entity's financial statements. For example, one state requires local governments to maintain serial-numbered control over the issuance of dog licenses and requires the government's auditor to test and report failures to comply with the requirement.

4.6 The independent auditor may not be required by statute, regulation, or current reporting standards of the profession to report all compliance violations; nevertheless, legislators and the public may believe the auditor has such a responsibility. For that reason, the independent auditor and the executive and legislative branches of the governmental client and senior governments should agree in advance on the responsibilities of the independent auditor in compliance areas. Their expectations may well exceed the independent auditor's inherent responsibility to be concerned only with noncompliance matters that may have a material effect on the financial statements being examined. The auditor's role in compliance auditing is one of the most significant environmental differences between governmental and private sector auditing.

Auditing Considerations

Auditing Procedures

4.7 When planning the engagement, the independent auditor should identify and become familiar with the compliance requirements of the client. The following approaches may be helpful in identifying compliance requirements in an initial audit:

- Discuss compliance requirements with the chief financial officer and the government's legal staff to identify areas of particular concern. Identify compliance matters included in the charter, financial ordinances, and regulations that should be tested.

- Consider contacting, where applicable, the office of the state auditor or other appropriate state audit oversight organization to obtain its perspective on key compliance areas applicable to constituent communities, including state statutes, uniform reporting requirements, and so forth. Some states also operate municipal affairs offices that can help.
- Review materials available from other professional organizations, such as state societies of CPAs.
- Identify sources of revenue received by the entity and inquire about restrictions, limitations, terms, and conditions under which such revenue is received. Review any directly related agreements (for example, loans and grants) and inquire as to the applicability of any overall regulations of senior governments that apply to the revenue or accounting for the revenue.
- The audit divisions of senior levels of government from which grants are received usually can be helpful in identifying compliance requirements. They may identify compliance requirements separately or in a published audit guide.
- As further described in chapter 22, the OMB has published the major compliance features of larger federal grant programs the auditor should consider testing in performing a single audit of grant activity.

4.8 The independent auditor should consider the nature, timing, and extent of tests needed to be performed to become adequately assured that the client complies with identified requirements. The independent auditor also should inquire of management as to its knowledge of any compliance violations. Through their separate audit efforts, auditors of senior government departments and agencies also may have detected instances of noncompliance. The independent auditor should give consideration to reviewing their reports as well as discussing the results of those examinations directly with those other auditors.

4.9 Exhibit 4-1 on pages 32–33 provides examples from the wide spectrum of compliance requirements that may apply to state or local governmental units. The examples illustrate the range of compliance requirements, which vary from state to state and among the several different forms of local government.

4.10 A significant compliance area the independent auditor evaluates in virtually all audits of governments is compliance with the budget. The independent auditor of a governmental entity should be familiar with the budgetary process and compliance requirements and consider them carefully in developing the audit plan. Chapter 6 further discusses governmental budgets.

Compliance Reporting

4.11 Because of the many compliance requirements that exist in a governmental environment, the auditor should expect to report on more varied forms of noncompliance. Noncompliance may include the following:

- Expending funds in excess of authorized limits, such as purchases in excess of budgeted amounts regardless of whether they were otherwise properly approved, received, and paid
- Expending funds for unauthorized purposes such as expending grant funds for purposes other than permitted by the grantor
- Failing to file reports required by the state and federal government accurately, completely, and on time, such as monthly reports of grant expenditures required by OMB Circular A-87 containing errors or filed late

4.12 Reporting on noncompliance may be complex and time consuming because the auditor is frequently expected to serve simultaneously the compliance interests of the executive and legislative branches of the local government, senior governments, grantors, and creditors. Further, compliance reporting can be difficult because the parties may establish different criteria for determining the nature and magnitude of exceptions or results to be reported to them.

4.13 Reporting on compliance takes two forms: (a) reporting in conjunction with the examination of an entity's financial statements and (b) reporting associated with a separate compliance examination of individual grant or other contractual agreements.

4.14 *Compliance Reporting in Conjunction With Examination of Financial Statements.* The criteria for financial statement disclosure of significant compliance requirements do not differ greatly from those of private sector enterprises. As in the private sector, it is common in government to disclose in notes to the financial statements any significant covenants in loan agreements and restrictions on the use of the organization's assets. But specific compliance requirements or restrictions associated with recurring grant or entitlement programs usually are not disclosed because they are common. However, events of noncompliance that may have a material effect on the financial statements of the entity or its future operations should be considered for disclosure or recording.

4.15 The managements of some governments advocate routine disclosure of the status of separate grantor audits of grant or entitlement programs. In the absence of uncertainties related to claims for refunds asserted in connection with such third party audits, such disclosure is not considered necessary.

4.16 The management representation letter should address compliance matters. The auditor should consider the effect of identified noncompliance on the financial statements when preparing a report; FASB Statement No. 5, *Accounting for Contingencies*, provides guidance in accounting for and reporting on such matters.

4.17 Some events of noncompliance do not have material financial implications and financial statement disclosure of such matters is, therefore, not required. However, special consideration nevertheless should be given to those events for single audit and other purposes. As previously noted, the governmental environment includes many interested parties, each of whom has some interest in noncompliance matters. In some instances, interested parties may have a purely political interest in noncompliance matters and may seek to use such matters, no matter how insignificant, as political issues. Thus, the auditor should be aware of the political implications and potential adverse publicity inherent in such noncompliance matters when communicating the findings in a written report. In particular, the auditor should consider whether noncompliance matters identified in the examination have been communicated to senior officials in both the legislative and executive branches of the government being examined.

4.18 If the independent auditor agrees to perform an examination in accordance with the financial and compliance elements of the Standards for Audit issued by the GAO, the following additional reporting requirements should be followed:

> Either the auditors' report on the entity's financial statements or a separate report shall contain a statement of positive assurance on those items of compliance tested and a negative assurance on those items not tested. It shall also include material instances of noncompliance and instances or indications of fraud, abuse, or illegal acts found during or in connection with the audit. [page 28]

That requirement can be met by including such disclosures in the independent auditor's management letter, or preferably, in a separate report dealing exclusively with compliance matters since the intended audience for each may differ.

Separate Compliance Reports

4.19 *Compliance in Conjunction With Separate Grant Audits*. As previously described, in the course of an examination of financial statements or as a special engagement, the independent auditor may be asked to issue a separate compliance report. Reports on compliance with contractual agreements or regulatory requirements are described in SAS No. 14, *Special Reports*; grant compliance reports require additional comments.

4.20 If a separate report is required on the organization's compliance with federal, state, or local government grant agreements, the independent auditor should request that the grantor identify the areas of compliance that are expected to be covered in the compliance report.

4.21 Compliance reports are usually accompanied by a schedule of identified compliance exceptions, commonly referred to as questioned costs. Though Standards for Audit issued by the GAO requires the auditor to report material instances of noncompliance encountered, considerable controversy surrounds the definition of materiality. An OMB interpretation published in the *Federal Register*, page 36032, on August 8, 1983, requires that in connection with single audits, "all questioned costs . . . regardless of amount or level of materiality" must be reported. Accordingly, the independent auditor should report all exceptions and allow the grantor to determine whether further action is needed.

Fraud, Waste, and Abuse

4.22 SAS No. 16, *The Independent Auditor's Responsibility for the Detection of Errors or Irregularities*, and SAS No. 17, *Illegal Acts by Clients*, discuss the independent auditor's responsibilities concerning errors, irregularities, and illegal acts that may be detected during compliance testing or during an examination in accordance with GAAS. Additionally, chapter 5 of the Standards for Audit issued by the GAO states —

> The auditors shall extend audit steps and procedures if the examination indicates that fraud, abuse, or illegal acts may have occurred. The extended audit steps should be directed to obtaining sufficient evidence to determine whether in fact they have occurred and, if so, the possible effect on the entity's financial statements. [page 26]

If the independent auditor's examination indicates the presence of errors or possible irregularities, it is important to consider the

(continued on page 34)

Exhibit 4-1

Examples of Compliance-Related Requirements Applicable to State or Local Governmental Units

Grants and Entitlements

Federal	State and Local
General Administration and Accounting	
• Reporting and administration requirements related to federal grants (for example, OMB Circulars A-102, A-87, A-95, A-128)	• Reporting requirements related to federal pass-through and separate state grants
Specific Program	
• Revenue sharing reporting and operational requirements (for example, Department of Treasury regulations)	• Gasoline tax distributed by states to localities subject to separate fund accounting
• Regulations regarding construction of subway facilities (for example, Department of Transportation regulations and grant agreements)	
Special Audit Requirements	
• Special audit requirements set forth in GAO *Standards for Audit of Governmental Organizations, Programs, Activities, and Functions*	• State auditor establishes special audit requirements to be applied to local governments

- Mandatory public hearings associated with federal revenue sharing

Operating Practices

Laws and Regulations

- Budget adoption and execution procedures
- Limits on local government taxing authority
- Mandated procurement procedures
- Limits on types of activities or services local governments can perform
- Prescribed reporting for local government annual financial reports to be submitted to state
- Debt ceiling limitations and other debt issuance criteria
- Debt indentures limiting use of proceeds

implications of the audit contract. It may be interpreted as calling for a fixed scope of work and require authorization for any expansion. In fact, the OMB issued an announcement in the *Federal Register* that unequivocally states that the auditor has no authority to unilaterally expand the scope of a single audit. Thus, it is in the best interest of the auditor to insist that the basic audit contract and any extensions be in writing. A refusal to amend the audit contract to provide for mutually acceptable terms for the expanded work should be treated as a restriction on the scope of the audit.

4.23 SAS No. 16 states that the independent auditor should discuss material errors or irregularities with management that is at least one level above the level of those involved. SAS No. 16 and SAS No. 17 do not require the independent auditor to notify parties other than senior personnel within the audited organization. The decision to notify other parties is the responsibility of management. This literature presumes that the entity being audited is the entity that arranged the audit. In governmental auditing that is not always true. Standards for Audit issued by the GAO specifically provides for notifying the entity arranging for the audit. Moreover, the independent auditor may be contractually required to report such matters directly to the grantor agency or designated cognizant agency by agreeing to be bound by the terms of a grant agreement.

4.24 If the auditor's examination indicates the presence of errors or possible irregularities, and the auditor remains uncertain about whether those errors or possible irregularities may materially affect the financial statements, the auditor's opinion should be qualified or a disclaimer of opinion should be issued on the financial statements. Both SAS No. 16 and SAS No. 17 discuss situations in which the independent auditor may wish to consult with legal counsel about withdrawing from the engagement. Before withdrawing from the engagement, the auditor should report the irregularity or illegal act to an appropriate level within the entity or the entity arranging for the audit and to any other party to whom the auditor has a contractual obligation to report, for example, a federal cognizant audit agency or grantor agency.

Chapter 5

Planning and Conducting the Audit

5.1 In conducting an audit of a state or local governmental unit, the auditor should—

- Identify the engagement's reporting objectives.
- Consider the audit focus of governmental financial statements.
- Obtain an understanding of the governmental unit's operations.
- Evaluate factors affecting the scope of testing.
- Consider anticipated reliance on internal accounting controls.
- Establish the type of audit tests to be performed (audit approach).
- Establish the general nature and content of audit programs.

Planning the audit is required by GAAS, and the process continues throughout the examination. Early planning is useful in establishing the probable level and type of effort necessary to conduct the engagement.

5.2 The auditor should make sure the client clearly understands the terms, nature, and limitations of the engagement. The reporting objectives and other responsibilities assumed by the auditor should be clearly communicated to the client. The responsibilities accepted by the client, such as the need for written client representation and an agreement to allow the auditor to read any material issued by the client with audited financial statements, should also be explained. An engagement letter is useful in establishing the necessary understanding between the client and the independent auditor and such a letter is recommended. In a government setting, those matters are typically included in a formal contract.

Identification of Engagement Reporting Objectives

5.3 Identifying the specific reports to be rendered should be an early step in planning an audit. For example, in an examination conducted in accordance with GAAS, the auditor may be required to report on any or all of the following:

- General purpose financial statements (GPFS) of the reporting entity
- Comprehensive annual financial report (CAFR) covering the GPFS and combining and individual fund type and account group financial statements, schedules, and statistical tables. (The auditor may report on the combining and individual fund financial statements presented separately or in relation to the GPFS.)
- Component unit financial statements (CUFS), a GPFS for a component unit or oversight entity
- Component unit financial report (CUFR), a CAFR for a component unit or oversight entity
- Individual fund financial statements
- Special reports on, for example, compliance with bond indentures, or requirements of federal or state grants, regulatory agencies, or state auditors

Exhibit 18-1 on page 143 provides an overview of the relationship that exists in the hierarchy of governmental reports.

5.4 The auditor may be asked to expand the scope of the engagement for other purposes, for example, to issue a single audit report (Single Audit Act of 1984) related to federal financial assistance programs, as described in chapter 17. Also, the scope of the examination may be expanded to include reporting on economy and efficiency or program results as described in the Standards for Audit issued by the GAO. Moreover, the engagement may include a review of the "comprehensive annual financial report" submitted to either the GFOA or the Association of School Business Officials (ASBO) to determine if the report meets their respective reporting standards. In any event, care should be exercised to assure that the terms of the engagement are clearly defined, preferably in a written engagement letter.

Audit Focus

5.5 The GASB Codification deals with various aspects of financial reporting, including the requirements applicable to general purpose financial statements. Those financial statements are required to be presented in the combined statement format that presents fund types and account groups in side by side columns. The omission of an existing fund type or account group from the GPFS is a departure from GAAP. Existing audit practice is that audit scope should be set and materiality evaluations should be applied at the fund type and account group level, unless a lower threshold is required for other reasons, such as the compliance and single audit aspects of governmental audits, discussed in chapters 4 and 17. Thus, as in other audit circumstances, assessing the materiality of events and transactions in an examination of general purpose financial statements requires judgment and the consideration of many factors.

5.6 With respect to the auditor's reports on GPFS, established practice is that the fund types and account groups must be presented in the side-by-side format of governmental combined financial statements in order for an unqualified opinion to be expressed. The omission of a fund type or account group, other than because the related funds do not exist, requires a qualification in the auditor's report.

Understanding the Governmental Unit

5.7 The auditor should obtain an understanding of the governmental unit and considerations that could affect the scope and approach of the audit, for example:

- Services provided by the governmental unit
- Number of employees by governmental function
- Services provided by separate governmental departments and independent entities (for example, hospitals, schools, redevelopment agencies) and their relationship to the governmental unit to be audited (GASB Cod. sec. 2100, 2600, and J50 provide useful information in assessing which, if any, of the otherwise independent activities should be included in the financial statements of the governmental unit)
- The nature of any joint ventures
- The nature of any compliance auditing requirements

- An assessment of accounting and financial reporting systems; if automated, a general understanding of the type of EDP equipment used, personnel involved, and similar background information, including software packages and operating systems
- The number and nature of funds and account groups
- Departures from GAAP in the financial statements that could lead to opinion qualifications
- The form of government, for example, legislative body with governor or mayor as administrator versus legislative body with appointed manager
- An assessment of the management of the governmental unit, including its prior experience in government, affiliations, and duties and responsibilities of key personnel
- Factors affecting the continued functioning of the governmental unit, for example, the presence or absence of taxpayer initiatives that limit revenue growth, expenditure growth, or the addition of incremental services
- Special reporting requirements

5.8 The foregoing information can generally be obtained from charters, budget documents, recent official statements, prior comprehensive annual financial reports, the request for proposal, and similar documents. Alternatively, the information may be obtained through discussions with key members of management.

Factors Affecting the Scope of Testing

5.9 Before starting field work, the auditor normally analyzes certain key organizational and environmental factors that may affect the scope of the engagement. Some of the factors that should be considered are—

- The effectiveness of the overall financial controls, including, among other factors, the ability to operate within approved budgets and issue timely and accurate financial reports.
- The appropriate segregation of duties and responsibilities.
- The dependence of the governmental unit on one or more individuals to operate key programs or manage the budget or financial reporting function.
- The effectiveness of any internal audit function.
- Turnover of key personnel.
- Qualifications of key personnel.

- Federal or state requirements for expanded audit scope.
- Qualifications in prior years' auditors' reports.
- Reduction or elimination of federal or state grant funds to finance key local programs.
- The ability of key subsidiary accounting systems to produce data necessary to support financial statements.
- Decentralized or centralized records.

5.10 Those factors may substantially affect the nature, timing, extent, and mix of compliance and substantive testing required. In reviewing those factors, the auditor should concentrate on those that could involve material misstatements of the financial statements. In this connection, the auditor should consider, among other pronouncements, the guidance in SAS No. 39 and SAS No. 47.

5.11 The review is more complicated for large governmental units that have decentralized accounting activities. Controls at one or more locations may be substantially less reliable than at others. However, well-controlled, decentralized financial management may result in less audit effort than poorly controlled, centralized financial management. If component activities are operated with a high degree of autonomy, the audit may entail what amounts to two or more separate audits. In each situation, the nature, timing, and extent of audit tests should be appropriate for the circumstances.

Internal Accounting Controls

5.12 The auditor should consider internal accounting controls that may be significant. Such controls may relate to such areas as the following:

- The ability to demonstrate compliance with state statutes, local charters, and ordinances as applicable
- The effectiveness of the budget process
- The accuracy and comprehensiveness of internal financial reporting
- Existence of adequate policy and procedures manuals
- The documentation of manual and automated systems

Audit Approach

5.13 Planning the engagement should allow the auditor to design an effective audit approach. Because governmental units often maintain numerous funds and account groups, the procedures are most efficient if they are organized to avoid repetitive steps. However, if one or more component activities of the governmental unit are operated autonomously, those activities may need to be examined separately.

5.14 In designing the audit approach, the auditor should consider preliminary estimates of materiality at the fund type and account group level (see paragraphs 5.5 and 5.6) and anticipated reliance on internal accounting control. Substantive tests can be limited if appropriate controls exist and are tested and determined to be functioning.

Preliminary Planning

5.15 This phase includes —

- Reviewing prior years' financial statements, working papers, and permanent files.
- Reviewing interim reports.
- Reviewing current accounting and auditing pronouncements.
- Discussing the nature, timing, and extent of the auditing procedures with the client.
- Determining the need for special assistance (for example, computer expertise).
- Reviewing minutes, important agreements, and contracts.

Review of Internal Accounting Controls

5.16 This phase ordinarily includes, but is not limited to, obtaining a preliminary understanding of the control environment and the flow of transactions through the accounting system.

Compliance Tests of Internal Accounting Controls

5.17 This phase includes testing controls surrounding accounting functions to determine the degree of reliance that may be placed on the system in modifying the nature, timing, and extent of substantive tests required to be performed.

Substantive Tests

5.18 These procedures include tests of transaction and account balances, confirmations, analytical review procedures, evaluating compliance with regulatory requirements and debt covenants, budget compliance, review of litigation, claims and assessments, subsequent events, and the like. They are designed to determine the validity and propriety of specific classes of transactions and account balances.

Audit Programs

5.19 The auditor should develop an audit program and, in the course of the examination, be aware that the audit program may need to be changed because of, for example, unexpected results of testing internal accounting control, substantially changed facts, or unanticipated activities of the government. SAS Nos. 22 and 41, among other pronouncements, provide guidance on audit programs and other working paper documentation.

Other Matters

Representation Letters

5.20 Representation letters should be tailored to governmental accounting and financial reporting. They should address the items normally covered in audits of business enterprises but should also include governmental areas, such as —

- The inclusion of all component units.
- The proper classification of funds and account groups.
- Compliance with budget ordinances.
- Compliance with grant requirements.

5.21 Because governmental administration changes are common, the independent auditor may have difficulty obtaining representations because the officials have left the employ of the government. Their replacements or subordinates can provide representations to the extent they have knowledge. To support their representations, the replacements may find it helpful to obtain representations from other key employees who were responsible for financial matters during the periods in question. The auditor should consider such problems early in the engagement. Failure or inability to obtain written representations may result in a limitation on the scope of the engagement sufficient to preclude the independent auditor from expressing an unqualified opinion. (See SAS No. 19, *Client Representations*.)

Lawyer Letters

5.22 Lawyer letters of the type requested in commercial audits should be requested. They may be requested, for example, from the city attorney or the state attorney general, and outside counsel used on significant matters. If the government's chief legal officer or its outside legal counsel is not willing or able to provide all the information the auditor needs to form a conclusion on litigation, claims, and assessments, the independent auditor should plan early in the engagement the steps necessary to avoid a problem and discuss with the client the qualification that may be necessary when expressing an opinion. Where inside counsel provides the assessment of litigation, claims, and assessments, Interpretation No. 8 of SAS No. 12 should be considered (AICPA, *Professional Standards*, vol. 1, AU sec. 9337.24).

Applicability of Other AICPA Audit and Accounting Guides

5.23 Large governments may have a variety of component units, and planning should involve not only identifying applicable component units of the reporting entity, but also the accounting principles and financial reporting practices that should be used by specific component units. In addition to this guide, four other guides have been issued by the AICPA that address organizations involved in activities often conducted by units of government. Their applicability in a governmental environment should be determined. The following discussion provides guidance until these issues are addressed by the GASB.

5.24 *Hospital Audit Guide*. Government-operated hospitals generally should be reported as enterprise funds in accordance with the requirements of the *Hospital Audit Guide*.

5.25 *Audits of Colleges and Universities*. Practice has supported the applicability of this guide to government-operated colleges and universities in separately issued financial statements. Specific questions have been raised concerning its applicability to government-operated or tax-supported junior colleges. The guide's preface reference to its applicability to "community or junior colleges" (and colleges and universities) supports its application to government-operated or tax-supported institutions. Government-type activities or transactions conducted by such institutions, for example, property taxes, should be accounted for as specified in GASB pronouncements, while the remainder of the organizations' operations should be accounted for as specified by the colleges and universities audit guide.

5.26 *Audits of Certain Nonprofit Organizations* and SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*. A number of the types of organizations cited in this guide, for example, libraries, museums, cemeteries, zoological parks, and the like, carry on activities that are also conducted by some governmental units. If the activity is conducted in a fashion that complies with the criteria associated with an enterprise activity, this guide and SOP 78-10 provide useful guidance. If the activity does not meet the enterprise fund criteria in GASB Cod. sec. 1100.003, its reporting should be within the governmental funds of the sponsoring government and meet the accounting and reporting requirements of governmental fund accounting.

5.27 In those circumstances in which a component unit is included as part of a sponsoring governmental entity's financial statements and also issues a separate financial report, a question arises as to the need to apply accounting and reporting principles consistently in each report. That question is expected to be resolved by the GASB.

5.28 As described in each of the previously mentioned specialized industry guides, reports of those entities usually employ a multiple fund type structure often including, among others, general unrestricted funds, restricted funds, endowment or trust funds, and plant funds. If such an entity is included in a government's financial report, its financial position and results of operations included in the general purpose financial statements of the government should be based on all of its financial activity in accordance with GASB Cod. sec. 2600.004. Significant disclosures that might be obscured, such as the extent of restricted assets and liabilities, should be provided in notes or through alternative statement classifications.

5.29 If separate detailed financial statements of the entity are included elsewhere in the government's comprehensive annual financial report, they generally should be included in the format required by the individual guides, if applicable, and reconciled to amounts included in combining financial statements. When separate reports are issued, notes describing the separate activities should clearly describe their relationship to the sponsoring government.

Responsibility for Financial Statements

5.30 The auditor is frequently asked to prepare the financial statements for governmental units. When that service is performed, the auditor should ascertain that the officials of the governmental unit understand they are primarily responsible for the fairness of presentation in conformity with GAAP of the information in the financial statements. A statement to that effect should be included in the management representation letter.

Determination of Principal Auditor

5.31 As previously discussed, the GASB Codification recognizes general purpose financial statements as an appropriate reporting vehicle for governmental units. As discussed in chapter 2, the codification requires that related government activities or component units that meet the defined criteria be included in the general purpose financial statements of the principal governmental reporting entity. That requirement has resulted in frequent inclusion of component units whose financial statements are examined by auditors other than those engaged by the governmental oversight unit. In some cases the assets, liabilities, revenues, or expenditures (or expenses) of one or more component units may exceed those of the oversight unit. Those circumstances have raised questions about the application of SAS No. 1, section 543. That section requires a decision as to whether the auditor's participation in the examination is sufficient to allow the auditor to serve as the principal auditor and to report as such on the financial statements.

5.32 Considering the provisions of section 543 and the nature of governmental units and their financial statements, an auditor should meet each of the following requirements in order to serve as the principal auditor:

- Be engaged by the oversight unit as the principal auditor for the reporting entity
- Be responsible for examining at least the general fund, or the primary operating fund type if no general fund exists, of the oversight unit

Having met the principal auditor criteria, the oversight unit's auditor is required to exercise the responsibilities of that position. Those responsibilities include evaluating any adjustment, condensation, or reclassification of component unit financial data to conform to the presentation in the general purpose financial statements of the reporting entity.

5.33 Following the provisions of SAS No. 1, section 543, the principal auditor should decide whether to make reference to the other auditors. If reference is made to other auditors, the disclosure of the magnitude of the portion of the financial statements examined by the other auditors should also include an identification of the fund types and account groups in which the amounts are included. Examples 12 and 13 in Appendix A present opinion formats for principal auditor reference to other auditors.

Responsibilities of Component Unit Auditor

5.34 The auditor of a component unit might not be the same as the auditor of the oversight unit. In those circumstances it is important that an appropriate professional relationship be established between the two auditors. The auditor of the oversight unit (the principal auditor) assumes certain responsibilities under AU section 543 of the AICPA's *Professional Standards*. The component unit auditor may be required to facilitate the principal auditor's execution of professional responsibilities. In addition, the component unit auditor may also be expected to participate in preparing financial statements of the component unit on a different basis of accounting or on an alternative fiscal-year basis not typically prepared by the component unit for its separate reporting. It is important that the auditors and their clients reach an early agreement on reporting responsibilities, the persons who will be responsible therefor, and how the costs of preparing the reports will be borne by the entities. Coordination of activities is equally important in performing a single audit.

Auditor Independence

5.35 GASB Cod. sec. 2100 presents the concept of a governmental reporting entity. That section requires the financial statements of many agencies, organizations, and authorities (component units) previously considered to be autonomous to be combined with the financial statements of another governmental unit (oversight unit) to form a reporting entity.

5.36 Professional Ethics Executive Committee Interpretation 101-10 requires the auditor issuing a report on the combined financial statements of a governmental reporting entity to be independent of the oversight entity and each of the component units included in the report. Likewise, the interpretation requires an auditor issuing a report on a component unit that is material to the reporting entity to be independent of the oversight entity and each of the other component units; this is required because the material component units included in the reporting entity financial statements are subject to significant influence from the oversight entity. The auditor of a nonmaterial component unit needs to be independent only of that component unit. For the purpose of this interpretation, it is presumed that all component units included in the entity's financial statements are material unless the auditor can demonstrate otherwise. The interpretation points out that a member expressing an opinion on the financial statements of a governmental reporting entity should take reasonable steps to confirm the independence of auditors of component units in accord with SAS No. 1, section 543. The auditor should be familiar with the ethics interpretation and take steps to be sure of compliance with its provisions.

Joint Examinations

5.37 With the encouragement of governments, CPA firms have occasionally agreed to perform joint examinations. Independent auditors participating in a joint examination should arrive at a formal understanding of their respective responsibilities, usually by contract, including responsibilities for signing the engagement report, means of determining compensation of the parties, supervision of the engagement, working paper documentation, and review procedures. The responsibility for signing the report usually dictates the extent of working paper review and other professional requirements imposed on the participants. Chapter 18 discusses reports on joint examinations.

Part II
The Local Government Audit — Governmental Funds and Account Groups

Chapter 6

The Budget

6.1 The roles of the budget and the budgetary process in government differ from their roles in business enterprises and have far more significance in government than in business enterprises. The budget has the force of law in most governments and various aspects of the budgetary process are mandated by statute, charter, or constitutional provisions. Almost all states currently require political subdivisions to adopt budgets for at least their "general fund." Many statutes also require budgets to be adopted and reported for "special revenue" and "debt service funds" and, sometimes, for other funds of governmental units.

6.2 GASB Cod. sec. 1700 contains the following principle concerning budgeting, budgetary control, and budgetary reporting.

- An annual budget(s) should be adopted by every governmental unit.
- The accounting system should provide the basis for appropriate budgetary control.
- Budgetary comparisons should be included in the appropriate financial statements and schedules for governmental funds for which an annual budget has been adopted.

GASB Cod. sec. 2400 provides information about budgetary reporting.

Background

6.3 To perform an audit of a governmental unit, the auditor should understand the historical concepts of budgeting as well as current budgeting practices and procedures of governmental units.

6.4 The term *budget* dates from the Middle Ages. The term's earliest derivation appears traceable to Great Britain, whose budget system roots are found in the emergence of parliamentary control over the crown in the Magna Carta of 1215.

6.5 Budgeting in the United States was built on the foundations of practice and procedure developed in Great Britain. Abuses in public spending at the federal level, and in states and cities, over many decades brought frequent public demands for reform. By the early 1900s, budget reform and the organization of government usually went hand in hand with efforts to improve financial practices. By the mid-1920s, most major American cities had undergone a thorough reform in municipal financial practice and had established some sort of budget system.

Definition and Description of Budgets

6.6 The following discussion in GASB Cod. sec. 1700.106–.109 provides a helpful review of the definition and description of budgets.

> Types of Budgets. Defined in its most general sense, a budget is a plan of financial operation for a given period of time. Two types of budgets in terms of time span, annual budgets and long-term budgets, are commonly found in contemporary public financial administration.
>
> The *annual* budget authorizes, and provides the basis for control of, financial operations during the fiscal year. This is the type of budget recommended, whether or not required by law, and that should be appropriately controlled through the accounting system to assure effective budgetary control and accountability.
>
> *Long-term* budgets present estimates of revenues and expenditures or expenses (as appropriate) for a period of several years—usually four to six—and the proposed means of financing them. They are *planning* documents that typically emphasize major program or capital outlay plans, the latter being referred to as capital improvement programs or capital budgets.
>
> Budgets may also be categorized as either "fixed" or "flexible." *Fixed* budgets embody estimates of specific (fixed) dollar amounts. *Flexible* budgets embody dollar estimates that vary according to demand for the goods or services provided.

6.7 The adoption of legal long-term budgets represents a relatively recent trend in the evolution of public budgeting.

The Budgetary Process

6.8 A governmental unit is usually required to follow a prescribed legal procedure in adopting a budget. That procedure varies by state and locality but normally includes preparation of the budget by the chief executive, posting that budget for public inspection at a designated time and place and for a prescribed period, advertising a public hearing, holding the public hearing, and final legislative adoption of the budget. The budget is a legal financial plan. The legal authority to spend money and incur liabilities, referred to as *appropriations*, is contained in the budget. Usually, the budget is developed by the executive branch and enacted by the legislature.

6.9 There may be specific requirements for amending an adopted budget. For example, a supplemental appropriation necessary to increase a previously adopted budget may require much of the same formality as the adoption of the original budget. Also, authorization to increase, decrease, or transfer appropriations within or among budget categories or departments is generally covered by specific requirements.

6.10 Governmental units receiving federal revenue sharing funds and some other grants must also comply with prescribed requirements contained in the regulations concerning public hearings and when public notice must be given.

Budgetary Accounting and Control

6.11 Budgetary accounting is used to control expenditures and monitor revenues. Budgetary accounts are established in fund general ledgers as a useful procedural adaptation of the accounting system. Estimated revenues and appropriations adopted in the budget are recorded in those accounts. Information is thus available that allows management to continuously monitor compliance with budgets. Budgetary account balances are closed at year end, after serving their interim managerial control purposes.

6.12 Encumbrance accounting is also used for budgetary control, especially in the general and special revenue funds. Encumbrances, formal commitments to acquire goods or services not yet received, are recorded in the budgetary accounts to help make sure expenditures do not exceed appropriations. Encumbrances outstanding at year end are usually the equivalent of expenditures for purposes of determining compliance with the budget. Encumbrance accounting is discussed further in chapter 10.

6.13 The budget is sometimes not recorded in fund general ledgers. A governmental unit that does not record the budget in fund general ledgers should nevertheless maintain adequate records to assure compliance with budgets and to prepare budgetary reports.

Methods of Budgeting

6.14 Public sector budgeting is most commonly conducted using one of these methods:

- Object (line item) budgeting
- Program budgeting
- Performance budgeting

Object Budgets

6.15 An object budget emphasizes allocations of resources to given organizational units for particular objects of expenditure, such as salaries, supplies, services, and equipment. Object budgets may be organized to provide accountability at varying levels such as on department, division, or agency levels.

Program Budgets

6.16 A program budget emphasizes the cost of specific programs of governmental services without regard to the number of departments or divisions that may be involved. Objectives are established for each program and costs to accomplish the objectives are estimated. The advantage of a program budget is that it considers the aggregate costs of individual programs. A disadvantage is that it makes it difficult to impose accountability on individual departments or divisions.

Performance Budgets

6.17 Performance budgets cover programs but they emphasize output, units of work performed, or services rendered within each program, such as tons of waste collected in the rubbish disposal program. Performance budgets relate the input of resources to the output of service. Performance budgeting has not been widely implemented in practice, however, primarily because it is difficult to develop meaningful statistical data and maintain the necessary special accounting system.

Combinations of Budgetary Methods

6.18 Many budgetary systems are based on two of these three basic methods or even on all three. Many of the advantages of each method may be obtained in this manner. For example, a hybrid method may be used in which vouchers or supporting invoices are double-coded, or otherwise dually identified, so that they may be posted both to a traditional object (line item) budget and to a program budget. Reports comparing expenditures with appropriations under both methods may then be conveniently prepared for management. One method satisfies the requirement for stewardship and administrative control over department heads who expend appropriated funds; the other method measures the cost of programs of the governmental unit.

Financial Statement Presentation and Disclosure

6.19 A "combined statement of revenues, expenditures and changes in fund balances—budget and actual" is required by GASB Cod. sec. 2400.102 for the general and special revenue fund types and for other governmental category funds for which annual budgets have been adopted. If the budget has been amended during the year, the final amended budget should be presented. The budgetary financial statement required for GPFS should be prepared in accordance with the revenue and expenditure basis of accounting used to prepare the budget. If the budgetary basis differs from the accounting basis used for financial reporting, the budgetary amounts should be reconciled with the statement of revenues, expenditures, and changes in fund balances. The reconciliations should be presented either on the budgetary financial statement or in the notes to the financial statements. Such a reconciliation allows the reader to understand the differences.

6.20 Budgets for capital projects funds and special assessment funds are often prepared for a project time frame rather than annually and are, therefore, commonly not presented in annual financial statements. Expenditures of debt service funds are usually controlled through scheduled debt service commitments and may not be included in the annual budgetary process. If budgets are adopted for the debt service funds, or if annual budgets are adopted for capital projects or special assessment funds, they should be presented in the financial statements.

6.21 In circumstances in which no legal budget is required and none is adopted, presentation of budget versus actual results cannot be accomplished. That situation should be disclosed in a note to the financial statements and the otherwise required financial statement omitted. This should not result in a qualification of the auditor's opinion.

6.22 The operating level of proprietary fund types is usually determined by the demand for services rather than a fixed budget. If a budget is formally adopted, however, it may be viewed as an approved operating plan and presented as supplemental information or in the GPFS.

6.23 The governmental unit should include budgetary information for individual funds if it prepares a CAFR in accordance with GASB Cod. sec. 2400.106. Such information is typically presented in individual fund or combining financial statements and is considered supplemental information.

Auditing Considerations

6.24 Budgets, which are usually legal documents, are a required part of the GPFS and significantly affect the financial operations of the governmental unit. In practice, the independent auditor performs certain procedures with respect to the budget and budgetary process to consider whether legal requirements for adoption, amendment, control, and reporting have been met. Those procedures may include, but are not limited to—

- Examining statutes and ordinances to determine the legal status of the budget and its applicability to the various funds of the governmental unit.
- Determining the level of budgetary control, for example, object, department, program, or fund, and the adequacy of the accounting system to operate at that level of control.
- Determining the basis on which the budget has been prepared.
- Determining that the budgetary process was performed in accordance with statutes and ordinances, including required public notifications and public hearings.
- Determining that the final budget was properly approved.
- Determining that changes in the budget during the audit period were properly approved.
- Determining that any material excess of expenditures over appropriations in individual funds is disclosed. The independent auditor should consult with the government's legal counsel to determine if such excesses constitute a violation of law and to assure himself that such events have been adequately disclosed.

Chapter 7

Cash and Investments

7.1 Cash and investment transactions and operations of governments differ from those of business enterprises in several ways.

Nature of Transactions

Decentralization

7.2 Cash is often collected by governments for a variety of functions and in a number of locations, such as billing departments, courts, and recreational facilities. The collections often include many small receipts. Because those collections may not be under the direct control of a centralized treasury, control problems may exist in receiving, depositing, and recording cash.

Pooling of Cash and Investments

7.3 Governments commonly pool both cash and investments for physical custody, control, enhancing earnings capabilities, and ease of operations. Pooling cash may simplify collection, custody, and disbursement. In some cases pooling cash and investments may be prohibited in contractual clauses or through the effect of laws. For example, a bond indenture may prohibit pooling cash belonging to a "debt service fund" with the cash of other funds.

Restrictions

7.4 State statutes, local ordinances, or both usually limit the types of investments governmental units may acquire. Also, the use of cash and investments may be restricted by contractual or legal requirements. For example, bond proceeds may be restricted to a capital project.

Collateralization

7.5 State statutes often require cash deposits to be collateralized by the depository institutions with specified types and amounts of collateral. The purpose of designated collateral is to provide protection for deposits of the state or political subdivision.

Accounting Considerations

7.6 Cash and investment transactions in governmental units are accounted for in the same manner as in business enterprises. Accounting procedures, however, may be affected by certain other factors. Fund accounting requires the assets of each fund to be segregated in the accounting records. The convenience of pooled cash and investments may lead to unauthorized borrowing. For example, one fund may overdraw its share of a pooled cash account. Pooled investments may also require extensive analysis to determine a reasonable allocation of earnings. Earnings are sometimes allocated by legislative action rather than following the flow of investments. Such circumstances should be reported as discussed in the following section.

Financial Statement Presentation and Disclosure

7.7 Cash and investment balances are segregated into individual funds and presented in the financial statements of governments in the same manner as in the financial statements of business enterprises. It may be necessary to classify certain cash and investments as restricted assets to comply with legal or contractual requirements.

7.8 If a fund overdraws its share of a pooled cash account, the overdraft should be reported as a liability of that fund. Fund overdrafts of this type should be reported as interfund payables and receivables. In such cases, it is the responsibility of management to determine the fund that should report a receivable. In certain rare cases in which the right of offset among cash accounts exists, it may be appropriate to aggregate overdrafts with positive cash balances. To the extent that the pooled cash account is overdrawn in the aggregate, however, a liability to the depository institution should also be reported.

7.9 Disclosures for cash and investments normally include descriptions of the nature and extent of any restrictions or commitments, the valuation basis of investments, market value, and the methods used to allocate income from the investment of pooled cash. Consideration should be given to whether some investments might require additional disclosures, such as the terms or circumstances surrounding repurchase or reverse repurchase agreements. Further, consideration should be given to whether there is a need to record losses due to decreases in value. That would be necessary if there has been a substantial decline that is not due to a temporary condition. Further, consideration should be given to whether the liquidity needs of the governmental unit will require sales of investments at losses. In such circumstances, the auditor should consider whether the entity should recognize a decline in value as a loss as of year end.

Auditing Considerations

Audit Objectives

7.10 The principal objectives of the audit of cash and investments include obtaining evidence that—

- Cash and investment balances presented belong to the governmental unit.
- Cash and investments included in the financial statements of a governmental unit exist and no balances are omitted.
- If law requires depositing institutions to maintain designated collateral for public funds, such collateral is adequate.
- Cash and investment balances are fairly stated on a basis consistent with that of the preceding year.
- Investments are of types authorized by law and the investment policy of the governmental unit.
- Income, gains, and losses from investments are accounted for and allocated properly to the funds.
- Cash and investments are properly presented in the financial statements, and adequate disclosure is made of restricted or committed amounts and limitations on use.

Audit and Control Considerations

7.11 Several of the distinguishing characteristics discussed previously create significant audit and control challenges. Highly decentralized cash collection procedures potentially increase internal accounting control problems and increase audit risk. The auditor should consider the internal accounting controls over collection procedures at the various cash collection locations. Each location should have a segregation of duties to provide reasonable assurance of the completeness and accuracy of recorded cash transactions and balances. In some cases decentralization results when elected tax collectors function entirely separate from other governmental finance operations.

7.12 Controls should provide reasonable assurance of compliance with laws and regulations governing the collection, deposit, and investment of cash. Controls should also exist to provide reasonable assurance of proper segregation of cash and investments and of allocations of related earnings, gains, or losses among the various funds of the governmental unit.

7.13 The auditor should consider the controls designed to prevent improper interfund borrowings and prevent or detect unrecorded cash receipts such as fines and other sources of a high volume of individually small cash receipts.

7.14 There are activities, such as school activity funds, that are part of the reporting entity under GASB Cod. sec. 2100 but that typically are excluded if they are immaterial. However, cash shortages incurred through those activities may result in liabilities of the governmental unit.

Audit Procedures

7.15 Most ordinary procedures for the audit of cash and investments apply to such assets of a governmental unit. In addition, the auditor should—

- Consider whether all activities and locations receiving, maintaining, and expending cash and investments are under accounting control.
- Consider whether there is compliance with legal or official authority for all depositories and investments.
- Consider whether interfund transactions have been properly identified, classified, and approved.
- Review compliance with laws, regulations, and investment policies governing the deposit, investment, and collateralization of public funds.
- Consider the adequacy of collateral based on its market value.
- Consider the appropriateness of the allocation of earnings and gains or losses from pooled investments to individual funds.

- Consider whether the liquidity requirements of the governmental unit will require sales of investments at losses, which should be reported currently in the financial statements.

7.16 The auditor needs to gain an understanding of the nature of all significant types of investment contracts such as repurchase and reverse repurchase agreements in order to apply the above procedures to each type of investment. In the process, the auditor should consider the various types of risks, including business risk, market risk, credit risk, and risk of collateral loss, as well as the steps taken by the governmental unit to control those risks. Guidance on those matters is provided by the AICPA publication, *Report of the Special Task Force on Audits of Repurchase Securities Transactions*.

Chapter 8

Receivables, Revenues, and Interfund Transactions

8.1 Receivables, revenues, and interfund transactions of a governmental unit are closely related, and many audit procedures apply in common to them. Evidence supporting assertions in the balance sheet about receivables also supports assertions about revenues and interfund transactions in the statement of revenues, expenditures, and changes in fund balance.

Nature of Transactions

8.2 In a governmental setting, receivables usually arise as a result of either revenue or interfund transactions. The revenue sources may be the public or other governmental units. The nature of the interfund transactions can vary as discussed below.

Accounting Considerations

General Principles

8.3 The modified accrual basis of accounting should be used in governmental funds—general fund, special revenue funds, capital projects funds, debt service funds, and special assessment funds, in which most receivables, revenues, and interfund transactions are recorded. According to GASB Cod. sec. 1600.106, revenues should be recognized in the accounting period in which they become available and measurable under the modified accrual basis of accounting.

8.4 In that usage, the term available means collectible in the current period or soon enough thereafter to be used to pay liabilities that are owed at the balance sheet date. Measurable, of course, refers to the ability to quantify in monetary terms the amount of the revenue and receivable. Similarly, GASB Cod. sec. 1600.126 indicates that transfers should be recognized in the accounting period in which the interfund receivable and payable arise.

Receivables

8.5 *Revenue Related Receivables.* GASB Cod. sec. 1600.107 provides that governmental fund revenues that usually can and should be accrued (prior to receipt) include property taxes, regularly billed charges for inspection or other routinely provided services, most grants from other governments, and income taxes for which taxpayer liability has been established and collectibility is either assured or losses can be reasonably estimated. Deferred revenues other than those arising from grants are recorded when receivables are deemed to be measurable even though not available.

8.6 *Interfund Transaction Related Receivables.* Receivables are also created by loans or advances to other funds of the governmental unit, the generation of revenues in quasi-external transactions (such as payments in lieu of taxes due from an enterprise fund), and reimbursements due from other funds not received at the reporting date.

8.7 The collectibility of interfund receivables should be assessed the same as any other receivable. If a receivable from another fund is not deemed collectible, it should be written off, or the transaction should be classified as a transfer by each fund, depending on the substance of the original transaction.

Revenues

8.8 Some revenues are recognized when received in cash and, consequently, no receivable is recorded. Other revenues are recognized before cash is received and related receivables are established. The following discussion describes the recording practices applicable to several common sources of revenues of governments.

8.9 *Taxes.* Taxes are the major source of revenue for most governments. Recognition of tax revenue varies by type of tax because different types of taxes become measurable and available at diverse times.

8.10 *Income Taxes.* Many governments raise revenues through income taxes. Because of their significance to state governments, income taxes are discussed in chapter 16.

8.11 *Property Taxes.* Property taxes are ordinarily considered available if they are expected to be collected in no more than sixty days following the end of the year. If, because of unusual circumstances, the facts justify a period greater than sixty days, the governmental unit should disclose the period being used and the facts that justify the recording practice used. Recognition of property tax revenue is described in GASB Cod. sec. P70.

8.12 *Sales Taxes.* Sales taxes collected by merchants but not yet required to be remitted to the taxing authority at the end of the fiscal year should not be accrued. However, taxes collected and held by one government agency for another at year end should be accrued if they are to be remitted in time to be used as resources for payment of obligations incurred during the preceding fiscal year. (See GASB Cod. sec. 510.) To illustrate, when a state collects all sales taxes and within sixty days remits to cities and counties the amount collected for them, amounts held by the state for allocations on June 30 should be accrued by cities and counties with a June 30 fiscal year end. However, taxes collected by merchants during June and prior months but not required to be remitted until after June 30 should not be accrued by the state, counties, or cities.

8.13 *Licenses, Permits, and Other Similiar Fees.* Revenues from licenses, permits, and other similar fees are usually recorded when cash is received and the licenses or permits are issued.

8.14 *Special Assessments.* Current pronouncements provide that special assessment installments receivable should be recognized as revenue only when they become available. That usually results in recognizing revenue only in the amount of annual assessment installments as they are collected. The remaining assessed but uncollected installments are recorded as deferred revenue in the balance sheet of the special assessment fund. Expenditure recognition is the same as in other governmental funds.

8.15 Because most capital improvements associated with special assessment funds are incurred before assessment installments are collected, expenditures are often incurred well before revenues are recognized. That pattern of expenditure and revenue reporting normally results in a fund balance deficit throughout the life of the special assessment project. Classification of the fund balance deficit is discussed in chapter 12.

8.16 In practice, a number of governments have elected to avoid the fund deficit problem by recognizing the entire amount of assessment installments receivable as revenue in the year the project is begun. They contend that the exception that exists for reporting of special assessment debt as a liability of the special assessment fund must be accompanied by recognizing a parallel revenue reporting exception if fair presentation in conformity with GAAP is to result. Others assert that the matching principle applies and that revenues should be recognized as expenditures are incurred.

8.17 *Intergovernmental Grant Revenue*. Recognition of revenue from grants is described in GASB Cod. sec. G60. Generally, the appropriate accounting is accrual in that grant funds received before costs are incurred should be deferred and grant-related expenses incurred in advance of receipt of grant funds result in the recording of receivables and revenue.

8.18 *Interfund Transactions*. GASB Cod. sec. 1800.102-.107 defines and describes appropriate classification for interfund transactions. Such transactions are classified into the following groups:

- Quasi-external transactions and reimbursements
- Transfers (residual equity transfers and operating transfers)

Short-term advances between funds are accounted for as interfund receivables and payables. Long-term advances (receivables) require establishing a reservation of fund balance (chapter 12) to demonstrate the current unavailability of such receivables to meet current expenditures. If an inability to repay suggests that a long-term advance has become a "permanent" advance, depending on an evaluation of current circumstances, it should be treated as an equity transfer or expenditure based on the nature of the original transaction.

8.19 Receivables of all funds should be evaluated as to collectibility and, if necessary, allowances for uncollectible amounts estimated and established.

Financial Statement Presentation and Disclosure

8.20 The summary of significant accounting policies should describe the accounting principles applied in recording all material revenues. The description of the property tax revenue recognition procedures should follow the guidance contained in GASB Cod. sec. P70. If the amount of revenue may be subject to adjustment as, for example, when significant questioned costs may result from grant audits, reference should be made to GASB Cod. sec. C50 and FASB Statement No. 5 for appropriate disclosures.

8.21 The amount of interfund receivables and payables, by fund, included in the financial statements should be disclosed.

Auditing Considerations

Audit Objectives

8.22 Audit objectives for receivables and revenue include obtaining assurance that—

- The receivables are bona fide.
- The entity has legal ownership of the receivables and the legal right to collect them.
- The receivables are fairly stated at their net realizable value; an allowance for doubtful receivables, if warranted, has been properly determined and recorded.
- Revenue accounts include all transactions that relate to the period.
- Descriptions, classifications, and required disclosures are adequate.

Audit and Control Considerations

8.23 Desirable internal accounting control features related to property tax receivables and revenues include—

- Periodic comparison of assessment rolls to real estate property files for completeness.
- Periodic redetermination of property assessments.
- Annual reconciliation of current year's roll to the prior year's roll.
- Prompt updating of assessor's records for sales of property.
- Separation of tax collection function from all other financial functions.
- Establishment of specific written abatement and refund procedures.
- Individual tax bills totaled and compared to total tax levy before mailing.
- Recorded tax billings agreed to total tax levy.

- Authority to abate interest and penalties vested in an individual independent of the tax collection function.
- Authorization for disposal of parcels due to nonpayment of taxes independent of the tax collection function.

8.24 Internal accounting control features distinctively related to the sales, income, and other similar taxes; governmental and other receivables; and revenues include—

- Maintenance of a file of taxpayers, licensees, or permit holders and periodic and routine comparison of filed returns to the file to ensure that taxpayers are currently filing.
- Audits of tax returns conducted on a scheduled basis.
- Systems to assure compliance features of grants are monitored.

Audit Procedures

8.25 Audit procedures should be designed to achieve audit objectives and assure compliance with legal requirements, such as grant agreements, ordinances, and statutes. The following audit procedures should be considered when developing a plan for the audit of receivables and revenues.

8.26 *Confirmations.* Many receivables and revenues can be confirmed though, in some cases, audit evidence may be more readily obtained through application of alternative audit procedures. Confirmation of receivables provides evidence about the existence and ownership of a receivable but provides little evidence about collectibility. Collectibility is usually evaluated through examination of subsequent receipts and historical trends.

8.27 *Other Procedures.* Other audit procedures uniquely related to property tax receivables and revenues that may be performed include—

- Comparing current year's assessed value to prior year's assessed value and obtaining explanations of significant changes.
- Comparing ratio of taxes collected to prior year's experience.
- Reviewing computation of total assessed value for property.
- Reconciling ending receivable balance to beginning receivable balance, collections, levy, supplements, and abatements.
- Recalculating total tax levy.

- Determining whether the list of delinquent and uncollectible taxes, if required by law, was properly filed.
- Testing compliance with legal requirements pertaining to tax sales.
- Comparing current year's revenue from tax sales of property with prior year's.
- Determining whether property parcels have been improperly omitted or exempted from the tax rolls by comparing current assessment rolls to a map of the government or prior assessment rolls. Alternatively, determining that the total land area of property within the government's boundaries is consistent with the prior year.

8.28 Audit procedures related to sales, income, and other taxes; governmental and other receivables; and revenues may include —

- Comparing current year's actual revenue to current year's budget and prior year's actual.
- Reviewing the reasonableness of the government's indirect cost allocation plan and determining the propriety of amounts allocated to grant programs.
- Reviewing grant applications, agreements, contracts, budgets, and reports to determine that grant expenditures are in accordance with grant agreements.
- Reviewing grant records for material areas of noncompliance and questioned costs.
- For governments involved in matching fund grants, reviewing supporting documentation to support unit's contribution and determining whether any in-kind services meet grant terms.
- Considering the propriety and consistency of revenue recognition principles.
- Evaluating the adequacy of liabilities for probable income or other tax refunds.

8.29 Audit procedures related to interfund transactions and receivables may include—

- Determining that interfund transactions are properly approved.
- Evaluating whether the fund receiving an advance has the ability to repay the advance.
- Determining that permanent interfund advances have been recorded as equity transfers.

- Determining the amount of any interfund borrowing that has occurred indirectly through the use of pooled cash and investment accounts.
- Evaluating whether transactions have been properly classified (see GASB Cod. sec. 1800).
- Determining that reservations of fund balance have been established for long-term advances.
- If an internal service fund has a significant deficit or balance in retained earnings, determining whether fund revenue and related expenditures in the "served" funds should be adjusted to reflect the actual costs for the period.

Chapter 9

Capital Expenditures and Related Fund and Account Group Activity

9.1 Capital assets acquired by governments for the benefit of their overall operations are accounted for in the governmental funds and account groups. Such assets are reported in the general fixed asset account group. Auditing fixed asset activity in proprietary funds is discussed in chapter 13.

Nature of Transactions

9.2 General fixed assets activity takes place in a number of governmental fund types. Recurring purchases of fixed assets, including desks, furnishings, automotive equipment, and other small machinery and equipment used in the conduct of daily operations, are usually treated as expenditures of the general fund and included in the government's annual operating budget. In some circumstances, they may be financed with special revenue funds. Major projects, such as building construction, bridge construction, and similar activity, typically financed with the proceeds of bond issues or grants from senior levels of government, are usually accounted for in separate project funds within the capital projects fund type. Another fund type, special assessment funds, is used to account for property improvements, such as sidewalks and streetlights, that will benefit only a select group of property owners who will be assessed the cost of such improvements.

9.3 In some cases, assets constructed in special assessment funds are subsequently transferred to enterprise funds where they are used in ongoing businesslike activities. For example, water or sewer lines may be constructed in conjunction with the operation of a utility.

Accounting Considerations

9.4 In each of the aforementioned cases, the costs associated with the acquisition of fixed assets are treated as current period expenditures of the respective fund types. The expenditures are not capitalized in governmental funds and, accordingly, no attempt is made to allocate the cost of such assets among periods in the form of depreciation. GAAP provide for the maintenance of a special account group known as the "general fixed assets account group." That account group is required to establish and maintain a continuing accountability for fixed assets acquired. Accordingly, in the same period in which acquired asset costs are treated as expenditures in the governmental funds, they are simultaneously recorded in the general fixed assets account group by increasing assets and a contra account such as the "investment in general fixed assets" account. The provisions of FASB Statement No. 34 as amended for governments by FASB Statement No. 62, relating to capitalization of interest, should be considered. Some contend that those pronouncements apply to all general fixed assets, while others contend they apply only if the objective of charging a cost to future periods is applicable (FASB Statement No. 34, paragraph 7(b)). In either case, the amounts involved often are not material to the general fixed assets taken as a whole. Though no operating statement is provided for the account group, it is permissible to report depreciation in the balance sheet of the account group by crediting accumulated depreciation and debiting the investment in fixed asset account. However, that procedure is not required and is usually not practiced.

General Fund

9.5 The annual operating budget for each major department within a government usually includes as a separate category the amounts expected to be spent acquiring capital assets financed with general government revenues. An expenditure is usually recorded in the general fund if it is to be financed with general government revenues such as property taxes. It is usually recorded in a capital projects fund if it is initially financed with debt proceeds and capital grants. Other criteria for establishing a capital projects fund include the size of the expenditures contemplated and whether the project is expected to extend beyond one year.

9.6 In recent years, many governments have entered into lease purchase agreements, installment purchase contracts, or other forms of capital asset financing agreements. Lease accounting, as applied to governmental fund types, is described in GASB Cod. sec. L20. The cost of the asset is recorded in the general fixed assets account group and the principal amount of debt incurred (the lease liability), determined in accordance with FASB Statement No. 13, as amended and interpreted, is recorded in the "general long-term debt account group" as a liability. The aggregate lease liability is simultaneously recorded as an expenditure and an "other financing source" in the general fund or other governmental fund acquiring the asset. Payments under the agreement, both principal and interest, are recorded in the acquiring governmental fund in the same manner as other debt service payments.

Internal Service Funds

9.7 For certain activities governments often establish internal service funds within the proprietary fund category. The purpose of those funds, as further explained in chapter 13, is to facilitate what is believed to be a more equitable distribution of the cost of using those services among the various funds of the government. For example, governments frequently establish motor pool and data processing "internal service funds" (cost centers). The cost of acquiring capital assets is recorded in the internal service funds, and the pro rata cost of services, including asset depreciation, is billed to other governmental and proprietary funds that use the equipment.

Capital Project Funds

9.8 Capital project funds are used to account for the purchase or construction of major capital facilities used in the operation of general government that, because of their size and nature, are usually financed with the proceeds of debt that is repayable from future years' revenues and capital grants.

9.9 As with all governmental fund types, the fundamental focus of accounting in capital projects funds is on source and use of resources, rather than on cost of services. Expenditures are recorded in the periods incurred. A multi-year budget identifying the costs associated with the projects and the required financing is customarily approved by both the executive and legislative branches. Bond proceeds are recorded in their entirety in the period in which the bonds are sold, as "other financing sources." At the time the required bonds are sold and proceeds received, the liability is also recorded in the general long-term debt account group and an offsetting entry is made to "resources to be provided in future years," representing the repayment requirements that must be included in future years' operating budgets of the government. In contrast with the practice that existed before the issuance of NCGA Statement 1, when the recording of "bonds authorized" was permitted, no amounts are recorded until the bonds are sold.

9.10 As another source of funding capital projects, a government may receive a capital grant from another, usually senior, government. Accounting for such revenues is addressed in GASB Cod. sec. G60, which provides that a capital grant is earned when all significant terms of the grant have been met. Expenditure of funds is usually the prime factor for determining eligibility and thus compliance with grant terms. Therefore, revenues are recognized as expenditures are incurred. If the grant agreement provides for some level of local cost sharing, revenue recognition may also be contingent on compliance with the terms of that requirement.

9.11 Because matching revenues and expenditures is often (except in the case of grants) not attempted or required, the fund balance of capital project funds, as further discussed in chapter 12, usually represents amounts earmarked for completion of capital projects in future years. The resources represented by the fund balance are not usually available for other discretionary expenditures.

Special Revenue Funds

9.12 If fixed assets are acquired with special revenue funds, accounting for them should be the same as that described above for the general fund. Though the use of special revenue funds to record intergovernmental capital grants has been discouraged in recent years, some governments continue to record capital project activity financed with intergovernmental grants in this fund type. Generally, significant fixed asset expenditures financed with intergovernmental capital grants should be recorded as capital project fund activity.

Special Assessment Funds

9.13 Accounting for the debt related to fixed asset expenditures in a special assessment fund differs from recording practices in other governmental funds. Special assessment fund debt is reported in the special assessment fund balance sheet rather than in the general long-term debt account group and the proceeds received upon issuance of bonds are not recorded as an "other financing source," as in capital project fund accounting.

General Fixed Assets Account Group

9.14 Though the cost of capital assets acquired is charged to expenditures as incurred in governmental funds, continuing accountability for those assets should be maintained in the governmental reporting structure. An account group known as the general fixed assets account group is used for that purpose. As expenditures are made in governmental funds for assets acquired or constructed, the amount of the expenditure is capitalized in the general fixed assets account group. Similarly, if assets are sold, retired, or otherwise disposed of, their cost is removed from the general fixed assets account group. In the period of disposition, any proceeds received are normally recorded as revenue of the general fund, though some bond indentures or applicable laws may require that the revenue be recorded in a related debt service fund.

9.15 GASB Cod. sec. 1400.109 provides that reporting is optional for assets known collectively as infrastructure—roads, bridges, curbs and gutters, streets and sidewalks, drainage systems, lighting systems, and similar assets that are immovable and of value only to the government. Accordingly, though it may be useful to maintain records of the cost of such infrastructure assets, reporting them in the general fixed assets account group is not required but is encouraged.

9.16 To maintain adequate accountability, a physical inventory of the organization's fixed assets may be taken periodically and the records of the general fixed assets account group adjusted if necessary.

9.17 Because governments have accumulated fixed assets since their inception, which in many cases spans decades or longer, some governments have experienced difficulty complying with the requirement of GASB Cod. sec. 1400 for maintaining a general fixed assets account group. However, if the government desires to prepare its financial statements in conformity with GAAP, information on the cost of its fixed assets needs to be developed. GASB Cod. sec. 1400.012 permits use of estimated costs in establishing initial property records.

9.18 To establish initial property records, a government should normally do the following:

- Develop a reasonably complete and accurate inventory of the property and equipment owned, including identifying asset descriptions and approximation of the years of acquisition. An inventory of real property normally can be established through examination of land records. An inventory of equipment, particularly smaller items, is usually more difficult to assemble. Often, the only feasible means of establishing an initial inventory of equipment is by taking a physical inventory. Physically inventorying property is not difficult but can be time consuming and require a considerable amount of preparation and organization.

- State the assets at acquisition costs, based on records of their costs or through estimation procedures. One such procedure is to directly estimate the cost of the specific assets based on their acquisition dates and reference to manufacturers' catalogues or other information available through professional appraisal firms. Another such procedure is to estimate current replacement costs of assets and discount them to estimated acquisition costs through the use of indexes.

9.19 A government may perform such procedures internally or use outside professional assistance to establish inventories of fixed assets or to assign their costs. The choice depends on the amount of staff time available in the organization to devote to the project and the accuracy required by the intended future use of the information. The primary purpose of establishing the general fixed assets account group is to maintain physical accountability for the assets owned by the entity. Accordingly, though the accumulation of costs should be a goal of every government, a more practical estimation approach to the establishment of initial records is acceptable.

Assets Transfers

9.20 Occasionally, assets originally acquired by a governmental fund may be transferred to a proprietary fund. In the period in which such assets are transferred to a proprietary fund, the general fixed assets account group should be reduced for the cost of the asset. In the proprietary fund the asset should be capitalized and recorded as contributed capital at the original cost less an amount equivalent to the depreciation that would have been recorded had the asset been initially recorded in the proprietary fund and, if warranted, by an amount to reduce the asset to its estimated utility value. When assets are transferred to a proprietary fund, the related debt should be transferred if it is to be serviced by that fund.

9.21 APB Opinion No. 29, *Nonmonetary Transactions*, provides that a nonmonetary asset received in a nonreciprocal transfer should be recorded at the fair value of the asset received. GASB Cod. sec. 1400.113 provides that assets donated to governments for use in general government activities be recorded at estimated fair value in the general fixed assets account group. If those assets are of such a nature that their donation reduces the government's current or future expenditure requirements, the governmental unit may elect to report the donation in the affected governmental fund as an "other financing use" and an "other financing source" of resources.

Financial Statement Presentation and Disclosure

9.22 The presentation of assets capitalized in the general fixed assets account group follows conventional presentation principles. The following disclosures are generally incorporated in the financial statements or the notes:

- Details of general fixed assets, such as land, buildings, and equipment
- The basis for carrying assets in the general fixed assets account group, for example, cost or estimated cost
- Whether infrastructure assets are included or excluded from the general fixed assets account group
- Whether depreciation is recorded in the general fixed assets account group and, if so, the depreciable lives and methods of computation
- A reconciliation of changes in the general fixed assets account group during the year
- Capitalization of interest during construction (FASB Statement Nos. 34 and 62)
- Commitments under long-term construction projects
- The status of capital grants
- Pertinent data regarding capital and operating leases

Auditing Considerations

Audit Objectives

9.23 Though the accounting and reporting for capital assets in government involve some degree of uniqueness, auditing procedures for capital assets do not vary materially from procedures followed in other audit environments. Audit objectives should include obtaining evidence that—

- All fixed asset expenditures are recorded in the accounts.

- Assets recorded are reported in the proper amounts.
- Recorded assets exist.
- Depreciation, if recorded, is based on reasonable methods and lives and is properly calculated.
- Capital expenditures are properly classified.
- Capital expenditures comply with budgetary, legal, grantor, and contractual requirements.
- Assets disposed of during the year are eliminated from the general fixed assets account group and any proceeds are properly recorded.
- Legal and regulatory requirements have been adhered to or violations have been reported.
- Grants for intergovernmental cost-sharing capital projects have been properly recorded.
- Special assessment projects have been appropriately authorized and property owner assessments have been billed on time.
- Capital expenditures result in the capitalization of an equivalent amount in the general fixed assets account group.

Audit and Control Considerations

9.24 Government fixed asset acquisitions, particularly large projects, typically involve complex legal, contractual, and administrative requirements. For example, there are often legal regulations governing bidding and contract award procedures. Also, if funding is derived from a bond issue, there may be specific bond covenant compliance requirements. If part of the funding is derived from grants or other intergovernmental funds, for example, or if another unit of government provides a portion of the funds for a project, additional specific compliance requirements often need to be considered.

Audit Procedures

9.25 The audit procedures applied to capital expenditures and related fund and account group activities do not differ from those discussed in chapter 10 and those applied to the audit of capital assets of other types of entities.

Chapter 10

Expenditures and Related Liabilities

10.1 In governmental accounting, the term *expenditures* is used to indicate decreases in financial resources or increases in current liabilities and accordingly is not limited to cash payments. The auditor should understand governmental fund expenditures and related liabilities and the unique reporting practices in government related to certain expenditures.

10.2 Generally, expenditures can be classified as operating expenditures (for example, payroll, fringe benefits, or supplies), capital expenditures, or debt service expenditures. Capital expenditures are discussed in chapter 9. Debt service expenditures are discussed in chapter 11. Expenditures related to government grants and other assistance programs are discussed in chapter 17. In addition, chapter 8 discusses expenditures made by one governmental fund for another governmental fund and interfund transfers.

Nature of Transactions

10.3 The primary objective of governmental fund accounting is to reflect the sources and uses of financial resources. To meet that objective, the measure and focus in accounting for a governmental fund is on expenditures rather than on expenses. Governments generally make no attempt to allocate costs to periods benefited. That factor, together with applying an approach to defining a current liability that differs from the approach used by business enterprises, accounts for the use of the term *modified accrual accounting* to describe expenditure and liability accounting by governments.

10.4 An expenditure is usually recognized when the government has received and becomes liable for payment for goods and services.

That is, an expenditure should be recognized in the period in which the amount can be objectively measured, the goods or services have been delivered or received, and title has passed.

Accounting Considerations

10.5 There are unique aspects of accounting for certain governmental expenditures and related assets and liabilities in the areas of inventory and prepaid expenses, long-term liabilities, and encumbrances.

Inventory and Prepaid Expenses

10.6 Under current governmental accounting principles, a government may either record as an asset or charge directly to expenditures resources used for items of inventory or prepaid expenses. That is often referred to as the purchase (expenditure) versus consumption (capitalization) option. Some governments that adopt the consumption option also elect to transfer an amount equal to the year-end inventory on hand or prepaid expenses from unreserved and undesignated fund balance to a reserve for inventory or prepaid expenses. The reserve so created is treated in the same manner as an appropriation of retained earnings in a business enterprise. The intent of the transfer is to demonstrate the extent to which the fund balance is composed of resources that are not available for other discretionary expenditures.

10.7 Governments that adopt the purchase option nevertheless should report the amount of inventory on hand in their balance sheets at year-end. That is accomplished by recording the inventory and an offsetting reserve in the fund balance section.

10.8 Inventory in governmental funds usually consists of materials and supplies used in the performance of the governmental function rather than materials that enter into the cost of a product that produces revenue. In that sense, the governmental fund inventory, if recorded, is similar to prepaid expenses. Accordingly, governmental fund inventories are generally not written down from cost to lower market values unless the usability of the inventory is affected by physical deterioration or obsolescence.

Liabilities Resulting From Uninsured Risks

10.9 As a result of rising insurance costs, many state and local governments have elected not to insure a wide range of risks. Other governmental units have insurance policies that cover losses only in excess of extremely high amounts. Each of those situations is often improperly referred to as involving "self-insurance." In reality, it is *no* insurance.

10.10 The type of risks involved include, but are not limited to, workers' compensation and public liability. Many of those risk areas involve a high level of claims being filed very frequently. Accordingly, at any given time there are usually a significant number of claims in all phases of processing and adjudication. In addition, there will exist incurred but as yet unreported claims that are usually referred to as IBNR ("incurred but not reported") claims. Whether a government elects to record such liabilities and costs directly in individual funds or through an established internal service fund, it is important that costs of the claims are properly recorded in the funds assuming the risks and that the recorded liabilities represent unreported as well as reported estimated losses. Reference should be made to FASB Statement No. 5 and GASB Cod. sec. C50 for further discussion of the manner in which certain contingent liabilities related to uninsured risks should be recorded.

Amounts Resulting in Long-Term Liabilities

10.11 An expenditure for which payment is not immediately made or required by the governmental unit results in a liability, for example, an account payable, an accrued liability, or a long-term liability. If the liability is payable currently, it is recorded in governmental funds as a current or fund liability and a related expenditure. However, portions of certain governmental liabilities, such as claims and judgments, compensated absences, special termination benefits, and pension costs, may not be paid currently. The noncurrent portions of those liabilities should be reported in the general long-term debt account group, which is accomplished by increasing the offsetting "amount to be provided for retirement of general long-term debt."

Encumbrances

10.12 To assure that budgets are not overspent, most governmental units use an *encumbrance system* to keep track of outstanding purchase commitments that have not yet resulted in liabilities. GASB Cod. sec. 1600.123 defines encumbrances as "commitments related to unperformed (executory) contracts for goods or services." When a purchase order or commitment is placed, the governmental unit reduces the amount of budgetary authority remaining in the budget category and records an outstanding encumbrance. When the goods or services have been received, the encumbrance balance is reduced and the expenditure and a liability is recorded.

10.13 Encumbrances represent neither expenditures nor liabilities. In many governments, encumbrances outstanding at the end of a period are carried forward as a reservation of fund balance, with a corresponding reduction in unreserved fund balance.

Financial Statement Presentation and Disclosure

Expenditures

10.14 Governmental fund expenditures are presented in two different statements.

10.15 *A Combined Statement of Revenues, Expenditures, and Changes in Fund Balances—All Governmental Fund Types.* Expenditures are typically presented as operating expenditures, capital expenditures, and debt service expenditures. In addition, the operating expenditures are presented by function, such as general government expenditures or public safety expenditures. This statement presents expenditures and revenues on a modified accrual basis.

10.16 *A Combined Statement of Revenues, Expenditures, and Changes in Fund Balance, Budget and Actual—General and Special Revenue Fund Types* (and similar governmental fund types for which annual budgets have been legally adopted). This statement presents a comparison of budget to actual for all funds for which annual budgets are legally adopted. In this statement, actual results are presented on the same accounting basis as the budget, even though the budget basis may not conform to GAAP. The most frequent difference between budgetary accounting and GAAP is in the budgetary treatment of outstanding encumbrances as expenditures. Other differences may be related to the organization, timing, or format of the budget.

Liabilities

10.17 Current liabilities, commonly referred to as fund or short-term liabilities, are reported on the governmental fund balance sheet. However, as indicated previously, long-term liabilities are recorded in the general long-term debt account group. As noted in chapter 20, the definition of current liabilities is an unresolved issue.

10.18 *Disclosure.* The financial statements or the notes should include disclosures such as the following:

- The basis of accounting for expenditures and liabilities, for example, modified accrual accounting
- The extent to which budgetary control is exercised, for example, the level of detail covered by the budget
- The basis of budgetary accounting
- A reconciliation of budgetary basis of accounting for expenditures to financial statement basis (GAAP), if different
- The method of accounting for outstanding encumbrances at year-end
- The carrying value and accounting for such assets as inventory
- Disclosure of contingent liabilities

Additional guidance on disclosure is provided in GASB Cod. sec. 2300.

Auditing Considerations

Audit Objectives

10.19 The audit objectives for expenditures and related liabilities are similar to the objectives in the commercial environment—that is, to obtain evidence that all expenditures incurred during the period presented in the financial statements and related liabilities at the end of the period have been identified and properly supported, recorded, and classified. However, the following objectives are unique to governments:

- Obtaining evidence that expenditures are in accordance with the approved budget as to amount and purpose and with other regulations, for example, bid requirements
- Obtaining evidence that encumbrances are properly identified, supported, classified, and recorded

Audit and Control Considerations

10.20 Many governments use one system for purchasing, accounts payable, and disbursements regardless of the number of funds maintained by the governmental unit. Similarly, governments often use single payroll systems regardless of the work locations and numbers of funds maintained by the governments. Therefore, most of the testing of the system of all parts of a government can usually be done on a single expenditure or payroll system. However, some governments establish separate purchasing, accounts payable, disbursements, or payroll systems for federal grants, enterprise funds, or large special revenue funds such as school districts. The auditor should consider testing each significant disbursement or payroll system.

Audit Procedures

10.21 *Classification.* The auditor should consider whether expenditures are properly classified as to fund activity, character, and object class of expenditure and that expenditures made from federal or other grants are properly classified as to the grants from which the expenditures were made.

10.22 *Budgetary Reporting.* As previously noted, a governmental unit may report expenditures against a budget prepared on a basis different from GAAP. The actual expenditures included in the budgetary statement should be reported on the same accounting basis as the budget. The independent auditor should review appropriations, ordinances, transfer resolutions, and other documents to understand the budgetary expenditure and authorization process. Further, the independent auditor should consider whether the budget was prepared in accordance with the applicable laws and regulations. The independent auditor should also review the reconciliation between the budgetary and the GAAP financial statements. A further discussion of the budget is included in chapter 6.

10.23 *Pensions.* The provisions of APB Opinion No. 8, FASB Statement No. 36, and GASB Cod. sec. P20 and Pe5 should be considered in relation to reporting pension costs in governmental funds (see chapter 20). As in other circumstances, independent auditors should consider the necessity to qualify their opinions if the governments or the plan administrators cannot provide information adequate to evaluate the management judgments required by those pronouncements. Further, the auditor should evaluate whether the governmental unit is consistently following one of the alternatives permitted by the above pronouncements.

10.24 Both contributions and benefits may be defined by state or local statute. The auditor should determine that contributions made meet legal requirements and that benefits are paid or accrued as required.

10.25 A second principal consideration occurs if statutorily defined contributions exceed or, as is more frequently the case, are less than pension costs as defined by APB Opinion No. 8, FASB Statement No. 35, or GASB Cod. sec. Pe5. If so, the cost should be recorded in accordance with GASB Cod. sec. Pe5.

10.26 *Encumbrances.* The independent auditor should determine that encumbrances have been properly identified at year-end and are properly reported on the financial statements. In addition, if encumbrances must be reappropriated the independent auditor should examine the appropriation document for the subsequent year to make sure such action has taken place. In addition to performing a search for unrecorded liabilities, the independent auditor should review the records for unrecorded encumbrances. Also of particular concern, the auditor should determine that recorded encumbrances are supported by executed contracts, commitments, or purchase orders. Intentions to spend are recorded as designations of fund balance, not encumbrances.

10.27 *Legal Basis.* As discussed in chapter 4, many financial activities of governmental units are affected by local, state, or federal law. The auditor should consider that there may be laws and regulations applicable to areas such as the following, that may have a direct effect on the financial statements:

- *Purchasing.* Many governments require competitive bidding before buying certain types of goods or services.
- *Payroll.* Often salary rates, salary reclassifications, salary changes, and various hiring and termination rules are subject to special review and approval requirements in local or state ordinances as well as in union agreements. In addition, entities receiving federal grants may be subject to certain federal regulations such as the Davis-Bacon Act.
- *Travel Expenses.* Many jurisdictions have specific ordinances and policies related to travel.
- *Bond Covenants.* Many bond covenants contain restrictions on expenditures.
- *Grants.* Grants may allow expenditures for only specified purposes or may require that expenditures be incurred in accordance with specific regulations or budgets.

- *Program Expenditures*. Statutorily authorized programs may require that expenditures be incurred in accordance with specific regulations or budgets.

10.28 *Long-Term Liabilities*. The independent auditor should test long-term liabilities to evaluate whether they are properly recorded in the general long-term debt account group. In addition, the independent auditor should test whether the current portion of such long-term liabilities is properly reported.

Chapter 11

Debt and Debt Service

11.1 Governments borrow money on a short-term basis either to meet seasonal cash needs or in anticipation of long-term borrowings at later dates. They usually borrow long term to finance construction but, in limited circumstances, also for other purposes, such as funding judgments against the governments.

11.2 Local governments are customarily presumed not to have implicit power to borrow. Their authority to borrow is usually contained in the governments' charters or in state statutes. Such authority may also prescribe the form and general terms of permitted indebtedness. Approval by governing boards or voter referendums is frequently required.

Nature of Transactions

Short-Term Borrowing

11.3 Governments conduct short-term borrowing in several ways. For example, they borrow using tax anticipation notes collateralized by specific tax collections. Grant anticipation notes usually require pledges of the related grants receivable. Some revenue anticipation notes may be collateralized by revenue from a number of sources as well as by unpledged assets of the governmental units.

11.4 Bond anticipation notes are used primarily to provide interim construction financing. They are usually retired with the proceeds of long-term debt when issued. Terms of such notes are normally twelve months or less. They are frequently refinanced by replacement notes if the original notes mature before the long-term debt is issued. The issuance of the long-term debt may be delayed pending improvement in market conditions. However, in the government sector it is not uncommon for long-term debt to be issued before construction projects begin.

Long-Term Borrowing

11.5 Long-term debt of governments includes general obligation bonds, special or limited obligation bonds, capital leases, and other obligations with long-term repayment schedules. Revenue bonds are also discussed in chapter 13.

11.6 *General Obligation Bonds.* General obligation bonds pledge the full faith and credit of the government. Specific authorization for each issue of such bonds is often required in addition to general statutory authority for issuance. For example, a statute may permit a government to issue general obligation bonds up to a certain maximum, but each issuance may require the prior approval of a senior governmental unit. Because future annual principal and interest payments are supported by the taxing power of the governmental unit, prior voter approval is also often required.

11.7 *Special Bonds.* Special or limited obligation bond authorization procedures are similar to those followed for general obligation bonds. Specific receipts, such as certain fees or taxes, are often pledged to repay such bonds. However, the full faith and credit of the governmental unit is also usually pledged for such bonds.

11.8 *Other Long-Term Obligations.* Governmental units may enter into other long-term obligations. A typical example is an equipment purchase contract or a capital lease that provides for installment payments over a period of years. A governmental unit may have additional long-term obligations that are not debt as defined in this chapter, such as obligations for pensions, employee benefits, and other claims, judgments, and compensated absences; they are discussed in GASB Cod. sec. C50, C60, P20, and Pe5. Those types of obligations should be included in the general long-term debt account group together with long-term debt.

Guarantees and Other Commitments

11.9 In addition to formal debt, a governmental unit may be involved in guarantees, so-called moral obligation indebtedness, and no-commitment bonds.

11.10 *Guarantees.* Guarantees relate to the debt issue of another entity, for example, a local governmental obligation guaranteed by a state.

11.11 *Moral Obligations.* An entity may issue bonds for which another entity has assumed a moral responsibility that is not an enforceable promise to pay. An example is a debt issued by a government for which the state government is obligated, in the event of default, to consider assuming responsibility for total repayment or to consider annually the necessity to provide the required payments to debt service funds. Such an obligation is usually unenforceable unless adopted by the state legislature.

11.12 *No-Commitment Debt.* A government entity may authorize the issuance of debt bearing its name for the benefit of an organization that is not a component unit as defined by GASB Cod. sec. 2100, and for which it assumes no responsibility for repayment, for example, industrial development bonds. The funds provided from the sale of such debt are usually used in the public interest, such as for hospital construction or expansion of private businesses to increase employment or the government's tax base. Normally, such debt is repayable only by the entities for whom the debt is issued. No-commitment debt explicitly states the absence of obligation by the government other than possibly an agreement to assist creditors in exercising their rights in the event of default.

Accounting Considerations

11.13 Short-term obligations of governments are recorded directly in their governmental funds, consistent with the current operating measurement focus ascribed to governmental fund accounting. In contrast, general government long-term obligations are recorded in a separate set of accounts known as the general long-term debt account group. Bond anticipation notes should be classified as long-term debt if the criteria of GASB Cod. sec. B50 have been met. Demand bonds meeting the criteria of GASB Interpretation No. 1 also should be reported as long-term debt.

Capital Leases

11.14 Capital leases also create long-term obligations. The present value of minimum lease payments represents the amount of the initial debt. The provisions of GASB Cod. sec. L20 should be followed.

11.15 If the lessor is a component unit as defined in GASB Cod. sec. 2100, such as a building authority created by the governmental unit solely to finance construction for the governmental unit, the leasing transactions of that entity should be consolidated with those of the governmental unit. The debt of the lessor is reported as the debt of the governmental unit and the debt between the lessor and the governmental unit is eliminated. Capital leases are further discussed in chapter 9.

Reporting Proceeds of Debt

11.16 The accounting procedures for recording governmental fund debt depend on whether the debt is short- or long-term and whether the debt is general or special assessment debt.

11.17 Proceeds received by a governmental fund in exchange for short-term debt should be recorded as a debt in the governmental fund in the conventional fashion in which debt is recorded in the commercial sector. However, proceeds received for long-term debt should normally be recorded as an "other financing source" in the statement of revenues, expenditures, and changes in fund balance for that fund and the principal should be recorded in the general long-term debt account group.

11.18 Special assessment debt, both short- and long-term, though incurred by a type of governmental fund, is reported directly in "special assessment funds." As discussed in chapter 9, repayment of special assessment debt is provided from resources provided by individual property owners who are subject to the special assessment levy.

11.19 A discount on general long-term debt is reported through the recording of diminished proceeds in the receiving fund, but a premium received in excess of the face amount of debt may be recorded in either the receiving fund or related debt service fund. Accordingly, premium or discount on long-term debt issued by governmental funds is usually not amortized. The face amount of the obligation is recorded in the general long-term debt account group and offset by a charge to the account "amount to be provided in future years."

11.20 General obligation bonds collateralized by the taxing power of the government but expected to be retired from proprietary fund revenues should be reported as liabilities in proprietary fund financial statements rather than in the general long-term debt account group. As discussed in chapter 9, certain special assessment debt may also be included in the proprietary fund.

11.21 Care should be exercised to ensure that the financial statements appropriately identify those elements of the indebtedness that are secured by the full faith and credit of the government.

Recording Principal and Interest Expenditures

11.22 Making payments on debt principal and interest is referred to as debt service. The recording of governmental fund debt service depends on whether the debt is short- or long-term and whether the debt is general government or special assessment debt. Payment of short-term debt is recorded in the fund in which the debt is recorded, as a reduction of the recorded liability.

11.23 Long-term debt usually requires annual principal payments and semiannual interest payments to outside fiscal agents or individual bond holders. The general long-term debt should be recorded in the general long-term debt account group until a principal installment is due. On the due date the current installment of principal should be removed from the general long-term debt account group and recorded as an expenditure and liability of the applicable debt service fund or other paying fund. However, the entire debt of a special assessment fund should be reported as a liability of the fund regardless of when the debt matures. One of the unique aspects of governmental fund accounting is that interest cost generally is recognized as an expenditure in the accounting period in which it is due, rather than when it is accrued.

11.24 A general obligation debt indenture may establish requirements for the accounting and reporting of debt service resources. Also, many general obligation bonds create separately identified tax levies collected in amounts that are sufficient and timely to meet the principal and interest payments when due. Though only required when mandated by law or agreement, an individual debt service fund is usually established for each debt issue.

Advance Refundings and In-Substance Defeasances

11.25 If new bonds are issued to repay existing debt (refunding), the new liability (the refunding bonds) should be recorded in the general long-term debt account group. The proceeds of the new issue should be recorded in the debt service fund and recognized as an "other financing source." As the proceeds are used for retiring the existing bonds (the refunded bonds) or by payment (face amount) to a trustee for the retirement of such bonds, expenditures should be recorded in the carrying amount of the related bonds and the difference between the carrying amount and the amount paid should be recorded as a gain or loss. If the refunded bonds are either retired or defeased (in substance retired) as a consequence of the refunding, they are removed from the general long-term debt account group. If the old debt is defeased, that fact should be disclosed in the notes to the financial statements. Reference should be made to GASB Cod. sec. D20 and FASB Statement Nos. 22 and 76 for further guidance in dealing with advance refundings.

Financial Statement Presentation and Disclosure

Presentation

11.26 Several points discussed earlier require emphasis in the preparation of financial statements of governmental funds. For convenience, they are repeated here.

- Short-term governmental fund debt should be recorded as a liability directly in the issuing fund, except for bond anticipation notes meeting the criteria of GASB Cod. sec. B50.
- Demand bonds meeting the criteria of GASB Interpretation No. 1 should be recorded as long-term debt.
- Special assessment short- and long-term debt and the repayment thereof should be recorded in the special assessment funds.
- General obligation long-term debt to be repaid from governmental funds should be recorded in the general long-term debt account group and offset by these contra accounts: "amount available in debt service funds" and "resources to be provided in future years."
- General obligation bonds to be repaid from proprietary funds should be recorded in the related proprietary fund.
- Amounts due for the principal portion of capital leases should be recorded as debt.
- The proceeds of general obligation long-term governmental fund debt should be recorded as an "other financing source" in the governmental fund that receives use of the bond proceeds.
- Principal and interest payments on governmental fund debt should be recorded as expenditures in the fund designated to make the payments.

Disclosure

11.27 Financial statements should disclose the nature of any restrictions on assets related to debt. For assets reported in debt service funds, identification of the type of fund is considered sufficient disclosure. Other disclosures related to debt include—

- The nature of outstanding debt, including significant bond covenants.
- Debt service requirements to maturity.
- Details of capital leases.
- Amounts of authorized but unissued debt.
- Violations of significant bond covenants.
- Nature and amount of guarantees, contingent and moral obligations, and no-commitment debt.
- Changes in the amount of long-term obligations.
- The amount of unpaid debt that has been defeased.
- Debt incurred subsequent to the balance sheet date but before the financial statements are issued.
- An existing or anticipated inability to pay debt when due.

11.28 In addition to the above, guarantees should be disclosed in the financial statements of the entity providing the guarantee even if the possibility of default is remote. Further, the entity assuming a moral obligation should disclose such circumstances in the notes to its financial statements. With respect to no-commitment debt, because a default may adversely affect the government's own ability to borrow, practice supports disclosure of the existence of such debt in the financial statements.

Auditing Considerations

Audit Objectives

11.29 Many audit objectives related to the debt of governments are similar to audit objectives for debt of business enterprises. The governmental environment makes certain modifications of audit objectives necessary, however, and the auditor's concern related to long-term debt in that context includes obtaining evidence that—

- New debt issues are properly authorized.
- Indebtedness, including liabilities incurred under court order, lease purchase agreements, and other commitments, is identified and properly recorded or otherwise reported in the financial statements.

- Debt is recorded in the proper fund or account group.
- Debt and related interest payable are properly recorded and classified as to terms and payment status and disclosed in the financial statements.
- Taxes levied to service the debt are adequate.
- The entity has complied with provisions of indentures and agreements relating to indebtedness, particularly on use of proceeds.
- Debt restrictions are properly disclosed in financial statements or notes.
- Guarantees and other debt commitments are properly disclosed.

Audit and Control Considerations

11.30 There is a presumption that assets identified in the financial statements as restricted satisfy legal requirements or bond indentures unless there is disclosure to the contrary. If assets restricted for debt retirement include amounts due from other funds or from unrestricted assets of the same fund, there is an implication of noncompliance with the requirement for restriction of the assets. In such situations, the independent auditor should consider the adequacy of the accounting, disclosures, and other reporting considerations.

Audit Procedures

11.31 In addition to procedures followed in auditing other enterprises, the independent auditor should consider the following audit procedures related to a governmental entity's debt:

- Review legislative proceedings and enactments and inquire whether all debt bearing the name of the reporting entity or any of its component entities has been identified and is properly disclosed in the financial statements and notes.
- Review documentation and transactions for support of the intent and ability to pay general obligation debt from proprietary funds.
- Obtain information as to the existence of any guarantees or commitments related to the issuance of debt of other organizations.
- Review sinking fund calculations to determine the reasonableness of amounts accumulated to service debt.

Chapter 12

Fund Balances

12.1 Fund balances (equity) of governmental funds will be classified either as reserved or unreserved. The unreserved portion may be further classified as designated or undesignated. Generally, reserves are established to indicate a claim against assets or that for other reasons certain assets are not available for discretionary appropriation. Designations of fund balances originate through actions of either the executive or legislative branches of the government to control the future use of resources. Though many of the issues discussed below relate to presenting the amount of reserved and designated fund balance, the recording of amounts under such classifications is not a substitute for the proper recognition of liabilities and expenditures.

Nature of Transactions

12.2 Total fund balance may be segregated into a number of components under the broad categories that follow.

Reserved Fund Balances

12.3 Reservations of fund balance are established to identify (1) third-party claims against resources of the entity that have not materialized as liabilities at the balance sheet date, or (2) the existence of assets that, because of their nonmonetary nature or lack of liquidity, represent financial resources not available for current appropriation or expenditure, for example, inventories, prepaid expenses, and noncurrent assets (usually receivables). Such reserves are not intended as valuation allowances, but merely demonstrate the current unavailability of the subject assets to pay current expenditures. If a valuation allowance is required, it should be presented as a reduction of the carrying amount of the asset. In addition, if collectibility of an interfund receivable is doubtful, consideration should be given to reclassifying the amount as an equity transfer.

Unreserved Fund Balances

12.4 *Designated.* Designations of fund balance are established to identify tentative plans for or restrictions on the future use of financial resources. Such designations should be supported by definitive plans and approved by either the government's chief executive officer or legislature. Examples of such designations include the earmarking of financial resources for capital projects and contingent liabilities.

12.5 *Undesignated.* The fund balance remaining after reduction for reserved and designated balances is identified as the unreserved and undesignated fund balance. That amount is sometimes referred to as the "amount available for future appropriation." However, care should be exercised in the use of that term, because the amount available may differ depending on the budgeting methods employed by the government.

Changes in Fund Balances

12.6 Changes in the aggregate fund balances usually result from the following:

- Excesses (deficits) of revenues and other sources over (under) expenditures and other uses
- Residual equity transfers as defined in GASB Cod. sec. 1800.106
- Adjustments meeting the criteria of FASB Statement No. 16, *Prior Period Adjustments*

Accounting Considerations

Reserved and Designated Fund Balances

12.7 The following principles are important to an understanding of the accounting for reserved and designated fund balances:

- Establishing required reserved fund balances may create or increase a negative unreserved and undesignated fund balance.

- Designations of fund balances may not create or increase a negative unreserved and undesignated fund balance at balance sheet date regardless of the amount of fund balance that may have existed at the time of making the designation.
- Reserved and designated fund balances represent only classification of aggregate fund balances and should not be used to absorb future charges or credits.
- When no longer required, reserved and designated fund balances should be returned to the unreserved and undesignated fund balance.

Reserve for Encumbrances

12.8 Encumbrances, further discussed in chapter 10, represent commitments related to unperformed contracts for services and undelivered goods. If encumbered appropriations (budget authorizations) do not legally lapse, an amount equal to those encumbrances outstanding at year-end should be reclassified from the unreserved and undesignated fund balance to a "reserve for encumbrances" as a demonstration of contractual claims against the unreserved fund balance.

Reserves for Inventories, Prepaids, and Long-Term Assets

12.9 Reserves for inventories, prepaids, and long-term assets are established to convey that certain assets already committed to other purposes are not available for discretionary expenditure. Though, as noted in chapter 10, establishing a reserve for inventories determined on the consumption basis and prepaid expenses is optional, reserve accounting is required in cases where noncurrent assets are present.

Designated Fund Balances

12.10 Designations of fund balances are usually recorded as a demonstration of future expenditure intentions or restrictions as distinct from unperformed (executory) contracts that are reported as encumbrances. Designated fund balances are established by reclassifying amounts equivalent to the designations from the undesignated and unreserved fund balances to separately presented designated balances.

Financial Statement Presentation and Disclosure

Changes in Fund Balance

12.11 GASB Cod. sec. 2200.009 requires the presentation of "changes in fund balances." That information may be presented on a "combined statement of revenues, expenditures, and changes in fund balances." The fund balance reconciled in that statement may be either the unreserved and undesignated fund balance or the total fund balance. If the statement presents changes in total fund balance, material changes in reserves and designations should be disclosed in notes to the financial statements.

Balance Sheet

12.12 An example of the presentation of the fund balances of a governmental entity is presented in GASB Cod. sec. 2200.603, Example 1. In addition to accounts previously described, which relate principally to the general fund, the fund balances of other governmental fund types that represent assets restricted for special revenues, capital projects, debt service, and special assessments may be classified as reserved or designated. Designations in such funds may relate to identified portions intended for a particular purpose or to the fact that all balances are restricted to the purpose of the fund type. However, many governmental units do not classify such balances as designated on the basis that the nature of the respective fund types provides adequate information regarding intent. The following additional comments relate to other governmental fund types.

12.13 *Special Revenue.* The above discussion of fund balance reserves and designations applies to special revenue funds. Negative balances in such funds are rare because expenditures are not usually incurred in advance of the receipt of revenues or an event (signed grant agreement) that would support the accrual of revenues equivalent to the expenditures incurred.

12.14 *Debt Service.* The fund balance of debt service funds is held only for meeting debt service requirements. The fund balance of this fund type usually determines the "amount available in debt service funds" shown as part of the contra to liabilities recorded in the general long-term debt account group.

12.15 *Capital Projects.* Grant financial funding of capital projects is recorded by matching grant revenues and related expenditures. However, bond proceeds to be used for capital projects are recorded in capital project funds at the time those proceeds are received, irrespective of when expenditures are incurred. The fund balance usually represents unexpended resources designated for specific projects or reserved for outstanding encumbrances.

12.16 *Special Assessments.* The current accounting principles applied to special assessment funds result in presenting negative fund balances if expenditures are recorded as incurred but long-term installment assessments due from property owners are recognized as revenue when they become measurable and available, which usually results in recording revenues as they are received. However, as discussed in chapter 8, some governments avoid the problem by recognizing the entire amount of assessment installments receivable as revenue in the year the project is begun.

12.17 A negative balance should be classified as designated to be recovered through deferred revenue or, if taxes have not been assessed, as a reduction of undesignated fund balances of other special assessment funds.

12.18 Disclosures relating to fund balances should include identification of any negative fund balances of individual funds and plans for how they will be liquidated. It is also appropriate to disclose the purpose, intent, and basis for determining the amount of any designated or reserved balances not otherwise evident from descriptions included in the financial statements.

Auditing Considerations

Audit Objectives

12.19 The principal objectives of the audit of fund balances include obtaining evidence that —

- All fund balances and related transactions are reported in the financial statements in conformity with GAAP and in compliance with state and local regulations or requirements.
- The components of fund balance are properly classified and described.
- Reserves and designated balances are properly authorized.

Audit Procedures

12.20 The auditor should obtain evidence that reserves and designations have been properly supported and presented in the financial statements by review of the following:

- Minutes of the governmental body's meetings
- Provisions of the governmental unit's charter
- Applicable state statutes and changes in them
- State law, charter requirements, and so on, to determine whether encumbrances lapse at year-end
- Documentation supporting reserved fund balances to determine that they are required
- Documentation supporting designations of fund balances to determine that designations are required or approved by either the chief executive officer or the legislature
- Interfund operating and residual equity transfers to determine that they are properly classified

Part III
The Local Government Audit — Proprietary and Fiduciary Funds

Chapter 13

Proprietary Fund Types

13.1 Proprietary fund types consist of "enterprise funds" and "internal service funds."

Types of Funds

Enterprise Funds

13.2 Enterprise funds are used to account for activities for which the governing body (1) intends that the costs or expenses, including depreciation, of providing goods and services are to be financed or recovered primarily through user charges or (2) has decided that the periodic determination of revenues earned, expenses incurred, and net income is desired for purposes of facilitating management control and accountability.

13.3 Examples of enterprise funds in which user fees usually are charged to recover costs of rendering services include the following:

- *Utility operations*—water and sewer, gas, and electric
- *Recreation and cultural operations*—stadiums, arenas, sports facilities, and convention centers
- *Services*—parking garages, toll facilities, airports, and public docks

13.4 Enterprise funds in which periodic revenue or expense determination, capital maintenance, or separate accountability is often the motivating factor include, for example—

- *Hospitals*.
- *Transportation* activities in which fare collections usually do not cover costs, and subsidies from other funds or operating

grants from other governments are generally necessary to sustain operations.

- *Housing* and urban redevelopment activities in which tenant rentals or land rates cover only a portion of costs, and subsidies or operating grants are necessary to meet operating expenses.

Internal Service Funds

13.5 Internal service funds are used to account for goods or services provided by a central service department or agency to other departments or agencies of the governmental unit, or to other unrelated governmental units usually on a cost recovery basis. Accordingly, revenue and other financial resources of these funds should recover expenses, including depreciation.

13.6 Typical internal service fund activities include the following:

- Communications (telephone and mail)
- Data processing
- Printing and duplication
- Motor pools and maintenance operations
- Central supplies warehousing

Accounting Considerations

13.7 The cost recovery objectives of proprietary fund types are similar to those of commercial operations. Accordingly, accrual accounting is followed in accounting for these funds and commercial accounting principles are applicable.

Contributed Capital

13.8 The capital of proprietary fund types is often provided by contributions from (a) other funds of the governmental unit, (b) grants from senior governmental units (generally the state or federal government), or (c) utility system developers or users.

13.9 The use of capital grant funds received from other governmental units or organizations may be restricted to the construction or acquisition of specific fixed assets or other specific expenditures. Capital contributed by developers or users may be received in the form of assets or facilities other than cash (for example, utility system distribution lines).

13.10 The fund's records should identify the sources of its capital. The source of a fund's capital may be an important consideration in its rate-setting process. GASB Cod. sec. G60 permits an amount equal to depreciation expense on assets acquired with external capital grants to be closed to contributed capital accounts rather than to retained earnings.

Grants

13.11 Grants, entitlements, and shared revenues received by proprietary fund types for operating purposes or that may be used in support of either current operating expenses or capital facility acquisition at the discretion of the recipient government are recorded as "nonoperating revenues" in the accounting period to which they are attributable.

Customer and Developer Deposits

13.12 Many utility-type enterprise funds require customer deposits to assure timely payment for services. Deposits are normally required before service starts and are refunded when service is terminated. Land developers may also be required to make "good faith" deposits to finance the cost of extending utility service lines.

13.13 Unearned deposits from customers and developers are initially recorded as current liabilities in proprietary fund types. Customer deposits remain in current liabilities until applied against unpaid billings or refunded to customers. Developer deposits generally are reclassified as contributed capital when they cease to be refundable.

Billings and Customer Receivables

13.14 Governments usually bill utility customers on cycle dates on a monthly or multi-monthly billing basis. Cycle billing may result in material unbilled receivables at the end of an accounting period. For example, if meters are read and billed quarterly on cycle dates spread evenly throughout the quarter, an average of forty-five days' service for the entire customer base is unbilled at the end of the accounting period. However, consideration must also be given to the characteristics of the billing period, such as seasonal usage. GAAP requires that enterprise funds report estimated unbilled services, if material, just as is the case in accounting for a commercial utility.

Interfund Transactions

13.15 Proprietary funds may provide services to other funds that would be recorded as revenues and expenses if they involved parties outside the governmental unit. Such interfund, quasi-external transactions should be accounted for as if they involved outside parties—as revenues of the providing fund and expenses or expenditures of the receiving fund. Such interfund transactions generally constitute the principal source of revenues of internal service funds because those funds are established to serve user funds within the governmental unit.

Long-Term Debt

13.16 Proprietary funds, particularly utility-type enterprise funds, frequently finance capital construction by issuing general obligation bonds or revenue bonds. Revenue bonds usually are repayable solely from pledged revenues—hence the name *revenue bonds*—or they may be referred to as "double-barreled" bonds, which, in addition to the pledged revenue stream, are secured by a pledge of the full faith and credit of the issuing governmental entity.

13.17 Regardless of the type of security, such general obligation bonds and revenue bonds (and similar hybrid debt issues) should be recorded as liabilities of the proprietary fund type that initiates the issuance of the bonds, benefits from the proceeds, and will repay the debt. Revenue or general obligation bonds repayable by a proprietary fund type should not be recorded in the general long-term debt account group.

13.18 Most revenue bond indentures restrict the use of unexpended bond proceeds, and many restrict other activities of the issuer. For example, many indentures restrict the use of bond proceeds to the construction or acquisition of specific assets. Other forms of restrictions include maintenance of prescribed net income levels or requirements to use all or a portion of the fund's net operating income in meeting current debt service payments. A sinking fund also may be required to be established to set aside funds for payment of future debt service obligations. Other covenants may define how any unused proceeds of the bond issue may be used after construction is completed. Significant restrictions should be adequately disclosed in the financial statements or footnotes.

Property, Plant, and Equipment

13.19 Fixed assets may be constructed or acquired by proprietary funds from existing resources, from capital contributions or grants, or with borrowed funds. Fixed assets may also be acquired or constructed in capital project funds and contributed to proprietary fund types. Assets may also have been acquired through other funds in prior years, recorded in the general fixed assets account group, and later contributed to a proprietary fund. The latter is especially likely in the case of newly established proprietary funds. Assets transferred from the general fixed assets account group after some portion of the economic life of the assets has expired should be recorded in the proprietary fund at original cost net of depreciation that would have been otherwise recorded, and net of any economic obsolescence.

Systems Development Fees

13.20 Fees charged to join an existing utility system or for the extension of an existing utility system are commonly referred to as "tap fees," "connection fees," or "systems development fees." Fees related only to the physical connection to the system should be recorded as operating income. The related costs should be expensed. Amounts assessed that substantially exceed the cost to connect constitute capital contributions and are not revenue; they should be recorded as contributed equity. The auditor should test for appropriate recording based on those determinations and the underlying economic facts.

Revenue and Expense Determination

13.21 Charges for goods and services provided to other funds by proprietary funds should be at the same rates charged to outside parties, which should be at an amount at least approximating the cost, including depreciation, of rendering the service. Revenue is recorded by the fund providing the goods or services, and expenses or expenditures, as appropriate, are recorded by the fund receiving the goods or services.

13.22 If costs related to the operations of a proprietary fund are incurred by another fund (for example, general fund employee fringe benefits) and transferred to the proprietary fund, they should be recorded in accordance with GASB Cod. sec. 1800 as either a reimbursement or an operating or equity transfer.

13.23 If a proprietary fund provides rate regulated services of the type and under the conditions contemplated in FASB Statement No. 71, *Accounting for Certain Types of Regulation*, the provisions of that pronouncement should be considered.

Restricted Assets

13.24 If bond indentures restrict the use of unexpended bond proceeds or net operating income, amounts so restricted should be reported as restricted assets.

Special Internal Service Fund Considerations

13.25 Some internal service funds operate at a deficit, which generally means that the services provided have cost more than the amounts charged to user funds. A pattern of annual operating deficits, particularly if resulting in an accumulated retained earnings deficit, indicates that the fund has failed to adequately charge users for the cost of goods or services provided by the internal service fund. Fees charged for services rendered should be adjusted to eliminate annual and accumulated deficits or balances. Because the intent of these funds is to facilitate cost allocation, accumulation of resources or deficits over a long term is considered inappropriate.

13.26 "Self insurance" internal service funds should follow the provisions of FASB Statement No. 5 for recording liabilities and expenses.

Financial Statement Presentation and Disclosure

13.27 All enterprise funds and all internal service funds are combined in the general purpose financial statements (GPFS). The totals of those two fund types appear in separate columns under the heading "proprietary fund types" in the GPFS.

Segment Information

13.28 GPFS generally contain combined information and, accordingly, the segment information described in GASB Cod. sec. 2500 should be disclosed for enterprise fund types. Segment information usually is disclosed in the footnotes.

Summary of Significant Accounting Policies

13.29 A summary of significant accounting policies generally discloses revenue recognition practices, asset lives, methods used to determine and record depreciation on assets, allocations of receipts to contributed capital pursuant to GASB Cod. sec. G60, and other accounting policies normally disclosed in the financial statements of business enterprises.

Special Considerations—Government-Operated Hospitals and Universities

13.30 Governmental entities frequently operate hospitals and institutions of higher education. As discussed in chapter 5, the provisions of the AICPA *Hospital Audit Guide* and the AICPA *Audits of Colleges and Universities* generally apply to those activities.

13.31 Judgment should be exercised in determining the proper fund type in which to record health care activity. For example, governmental institutions for the long-term care of the elderly, the mentally retarded, or children are usually accounted for in the general fund rather than as enterprise funds because they are not user-fee supported. Hospitals operated by governments, however, generally should be accounted for as enterprise funds as provided by the AICPA *Hospital Audit Guide*, even if indigent care or contractual allowances are significant.

13.32 Similarly, junior or community colleges generally should be accounted for as provided by the AICPA *Audits of Colleges and Universities* even if tuition charges are nominal. Institutions of higher education are generally reported in the GPFS or CAFR as a separate fund type as permitted by GASB Cod. sec. 2600.109.

Auditing Considerations

Audit Objectives

13.33 Audit objectives for proprietary fund types are similar to those for business enterprises. However, as in the case with governmental financial statements generally, compliance with laws and regulations is a significant consideration.

Audit and Control Considerations

13.34 Proprietary fund types normally have the same internal accounting control concerns as all other funds of the reporting entity. However, the following areas frequently require special consideration.

13.35 *Cash.* The auditor should consider whether controls are satisfactory in areas such as public transportation fare-box collections, parking meter collections, lottery revenues, and student registrations.

13.36 *Separate Control Systems.* Many enterprise operations are conducted by quasi-autonomous component units operating separate from the sponsoring government. Accordingly, enterprise fund control systems will frequently require separate evaluation from the government unit's operation.

13.37 *Utility Billings.* Internal control systems should provide reasonable assurance that customers have meters, that meters are read, that unusual or illogical readings are investigated, and that the aggregate use indicated by the reading of individual meters is reconcilable to total use for the system.

Audit Procedures

13.38 *Rate-Setting and Billing Procedures.* The auditor should review any applicable regulatory rate-setting documents and the data supporting compliance with those regulations. The billing system should be tested to determine that the rates established are billed consistently and that any rate changes are incorporated into the system on a timely basis.

13.39 *Contributions and Grants.* The auditor should review grant and contract documents to determine any restrictions or compliance requirements and determine the amount of any noncompliance liability. A lack of compliance may result in a requirement to refund all or a part of the grant.

Chapter 14

Fiduciary Funds

14.1 The fiduciary (or trust and agency) fund type is used to account for assets held by governments in trustee (or fiduciary) capacities or in safekeeping capacities, as agents for third-party individuals, private organizations, other governments, or other funds or component units of the reporting entity. Fiduciary funds include "trust funds," "pension trust funds," and "agency funds."

Nature of Transactions

14.2 Transactions may differ substantially between trust funds, pension trust funds, and agency funds. Accordingly, each is discussed separately.

Trust Funds

14.3 Trust funds are used for assets under the administrative control of the government for extended periods of time. They may be subject to a variety of administrative or financial restrictions on the investment or management of the assets. However, the government typically exercises discretionary authority over the investment of trust fund assets. Contributions received for specific expendable purposes and certain grants or awards (for example, student loans) are included in this category. Trust funds are also commonly used to account for endowments, gifts, and awards from individuals or other governments (for example, library book acquisition trusts) that must be preserved while the income from the investment of such assets is available for the specified purpose.

Pension Trust Funds

14.4 Pension trust funds are used to account for activities related to public employee retirement systems (PERS). Pension trust funds are usually the most significant type of trust fund administered by state and local governments. The employees of some governmental units are covered by PERS administered by other governmental units; for example, teachers of a school district may be covered by a state PERS established for the benefit of substantially all teachers employed in the state. In that situation, the auditor of the school district may be concerned only with accounting and auditing considerations applicable to the employer governmental unit contributions. Where a PERS is included in the reporting entity, the auditor will be concerned with accounting and auditing of the PERS as well.

Agency Funds

14.5 Agency funds are custodial in nature. They report assets received for, and disbursed to, other entities or outside persons or groups. Agency funds report assets and liabilities; they do not report equity. Those assets and liabilities are accounted for on the modified accrual basis of accounting. Examples of agency funds include property tax funds maintained by a county or sales tax funds maintained by a state that are used to collect taxes for several units of government, student activity funds of school districts, or assets held by courts pending disbursements to beneficiaries.

Accounting Considerations

Trust Funds

14.6 Trust funds other than pension trust funds are classified either as "expendable trust funds" or "nonexpendable trust funds." Expendable trust funds, used where principal may be expended, follow the modified accrual basis of accounting. Nonexpendable trust funds, used where the principal must be preserved, follow the accrual basis of accounting. The discussion of interfund transactions in chapter 8 is applicable to trust funds.

Pension Trust Funds

14.7 Accounting for pension trust funds—both those administered by the reporting entity and those administered by other parties—is an area of significant unresolved issues.

14.8 If a PERS meets the criteria set forth in GASB Cod. sec. 2100, the PERS should be included in the governmental entity's financial statements. Pension trust funds are maintained on the accrual basis of accounting.

14.9 Under GASB Cod. sec. Pe5 (application has been deferred indefinitely by GASB Cod. sec. Pe5.152), a PERS records its investments at cost subject to adjustment for market value declines that are other than temporary rather than at market, as required by FASB Statement No. 35. Under GASB Cod. sec. Pe5.140, if debt securities are traded in exchange for new securities that have the same face value, either to improve yield or for other economic benefits (bond swaps), recognition of the gain or loss on the transaction may be deferred. If deferred, the gain or loss may be amortized over the life of the new or the old security, whichever is shorter, or the cost of the old security may be passed through the new security. The pass-through method is available for only two consecutive swaps per security. Bond swaps are defined as economic transactions planned simultaneously and executed on the same day.

14.10 In contrast to FASB Statement No. 35 (application has been deferred indefinitely by FASB Statement No. 75), GASB Cod. sec. Pe5 (also deferred indefinitely), requires that estimates of future salary increases be used in determining the actuarial liability of the plan. Until the GASB resolves these issues, governmental entities may follow either FASB Statement No. 35 or GASB Cod. sec. Pe5 in accounting for the pension trust fund. The entity's accounting policies should be consistently followed and disclosed.

Agency Funds

14.11 Agency funds often act as receiving and paying agents for various activities. The historical practice of using agency funds to account for vendor performance bonds or deposits and payroll withholdings should be discouraged because those transactions can be adequately accounted for in originating funds. In the interest of maintaining the fewest number of funds possible, transactions that may be accounted for as liabilities of a specific fund (for example, payroll withholding of general fund employees) should be so recorded, rather than using separate agency funds.

Investments of Trust Funds Other Than Pension Funds

14.12 With the exception of pension trust funds discussed above, investments of fiduciary fund types are accounted for in a manner similar to that of other funds, generally at cost. Material differences between cost and market should be disclosed. If cost exceeds market by a material amount, the auditor should consider the necessity for management to make an adjustment.

Financial Statement Presentation and Disclosure

Agency Funds Presentation

14.13 Agency funds do not conduct operations. The year's activity may be shown in a combining statement of changes in assets and liabilities—all agency funds, which is part of a CAFR, that presents changes in all assets and liabilities rather than only cash transactions. For GPFS, this statement is not required, but the information may be presented in the notes.

Summary of Significant Accounting Policies

14.14 Significant accounting policies to be disclosed include the basis of accounting for the fiduciary fund type, a description of the funds in use, the carrying basis of investments, and an explanation of any reservations of fund balance.

Pension Plan Information

14.15 Pension plan disclosures are covered by APB Opinion No. 8, FASB Statement No. 36, and GASB Cod. sec. P20 and Pe5. As discussed in FASB Statement No. 36, if the information necessary to apply FASB Statement No. 35 is not available, the information required by APB Opinion No. 8 must be disclosed. The information required by FASB Statement No. 35 is also required by GASB Cod. sec. Pe5. If at a minimum the information necessary to apply APB Opinion No. 8 is not available, the auditor should consider whether it may be necessary to express a qualified or adverse opinion. However, governments that participate in multi-employer plans often experience difficulty in obtaining pension plan data. Both FASB Statement No. 36 and GASB Cod. sec. P20 provide for modified disclosures in such situations. The auditor should be alert to new pronouncements in the pension accounting area, including the potential for differences between GASB and FASB pronouncements.

Auditing Considerations

Audit Objectives

14.16 The audit objectives of the fiduciary fund type should parallel those of other funds using the accrual or modified accrual measurement focus.

Audit and Control Considerations

14.17 Trust agreements or state or local statutes may impose special compliance requirements. In those circumstances, the auditor should obtain evidence of compliance with those requirements. That is particularly important if trust fund assets revert to residuary beneficiaries if noncompliance occurs.

Audit Procedures

14.18 The auditor should become familiar with the various compliance and fiduciary responsibilities of the entity. The principal areas of audit concern are control over assets and ensuring that they are used for the purposes intended.

14.19 *PERS Transactions.* PERS are generally comparable to pension plans in the private sector; hence, audit objectives are similar. Audit procedures in auditing governmental pension plans differ little in most areas from those for auditing private pension plans. The auditor is referred to the AICPA Audit and Accounting Guide, *Audits of Employee Benefit Plans,* which discusses those procedures. There are, however, some unique functions, aspects, and activities of PERS that require special attention.

14.20 *PERS Legal Requirements.* The auditor should consider whether investments meet applicable statutory requirements. The requirements may be set forth in state statutes or local ordinances or resolutions. The Employee Retirement Income Security Act (ERISA) does not presently apply to state and local governments.

14.21 *Pension Plan Administration.* When auditing the PERS, the auditor should determine who is responsible for pension plan administration, including the establishment of contribution level, authorization of payments, and reporting. Though the fiduciaries retain overall responsibility for the plan, it may be administered on a day-to-day basis not only by the sponsoring governmental entity, but also by a plan administrator, an investment advisor, a bank trust department, an insurance company, or a combination of those agencies. The auditor should understand where responsibilities for plan administration lie.

14.22 *Income Allocation.* Pension assets are sometimes combined with other assets of a governmental unit to enhance investment return in a *pooled investment* account. If so, the auditor should consider whether investment income is properly allocated.

14.23 *Actuarial Information.* In evaluating actuarial information, the auditor may consider using the work of an actuary. In that connection, the auditor should consider the guidance of SAS No. 11, *Using the Work of a Specialist.* That pronouncement, among other things, requires the auditor to test the accuracy of data submitted to the actuary. If the government does not have current actuarial data, the auditor should consider whether he should express a qualified opinion or disclaim an opinion.

14.24 *Participant Eligibility.* The auditor should consider testing the application of participant eligibility rules and statutory requirements and evaluating whether the rules are being followed consistently.

14.25 *Participant Vesting.* Vesting in the plan may be subject to statutory requirements. The auditor should test vesting computations for compliance and proper reporting and disclosure.

Part IV
Other Governmental Audit Engagements

Chapter 15

Special Units of Government

15.1 Special units of government usually provide single special-purpose services, in contrast with general units of government that provide broad ranges of services. School districts represent the greatest number of special units of government; other special units of government are usually referred to as "special districts." Such districts are formed to provide a variety of services and include the following:

Port authorities
Airports
Railroad terminals
Roads and bridges
Transportation
Industrial development
Parking
Public buildings
Libraries
Fire protection
Public health
Sanitation
Hospitals
Housing development
Water
Parks
Forest preserves
Soil and water conservation
River conservancy
Mosquito abatement

15.2 The 1982 Census of Government reports the existence of the following types of units of government:

Types	Number
General governmental units	
States	50
Counties	3,041
Cities, towns, townships, boroughs	35,831
Special governmental units	
School districts or systems	15,032
Special districts	28,733
Total	82,687

15.3 Depending on its organizational characteristics, a special governmental unit may be considered an independent reporting unit or an integral part of the oversight government. In the latter circumstances, the unit may elect or be required to issue separate financial statements. The preceding chapters described accounting, financial reporting, and auditing applicable to general units of government. The materials discussed in those chapters apply, in most cases, to special units of government. This chapter provides guidance in special situations encountered in auditing an independent special unit or a separately reporting component unit of the oversight reporting entity.

Applicability of Other Audit and Accounting Guides

15.4 The auditor should refer to chapter 5 of this guide if a special governmental component or separate unit may be subject to other audit guides. Other AICPA audit and accounting guides may apply to the following nonbusiness organizations frequently operated by governments:

- Hospitals
- Colleges and universities
- Certain nonprofit activities
- Employee benefit plans

Accounting Considerations

General Principles

15.5 *Independent Units.* All independent governmental units should prepare financial statements for use by their governing boards, constituencies, creditors, employees, and others. GASB Cod. sec. 2100 provides criteria to determine whether a unit is independent or a component unit that should be included in the financial statements of an oversight government organization.

15.6 *Component Units Reporting Separately.* GASB Cod. sec. 2600.118 does not prohibit a component unit of a reporting entity from issuing separate financial reports. Separately issued financial reports are often issued, particularly if the financial statements are to be used in official statements for sale of general obligation bonds, revenue bonds, or other debt. The relationship of the component unit to an oversight governmental entity should be disclosed in a note to the financial statements.

15.7 *Joint Ventures.* Joint ventures are often created by agreement among several governmental units, mainly to provide less costly and more efficient means of service delivery. Common examples are parks, water and sewage treatment facilities, airports and similar transportation facilities, and libraries. Further, a governmental unit may contract with a private enterprise for the enterprise to operate a facility or provide a service independently or jointly.

15.8 GASB Cod. sec. J50 discusses joint venture accounting. Generally, proprietary fund type joint ventures should be accounted for under the equity method. Governmental fund type joint ventures should be described in notes to the financial statements, if not reported using the equity method of accounting.

15.9 Though there is currently no authoritative governmental accounting literature on the subject, general accounting literature provides guidance for accounting for joint ventures in which significant influence is exerted by the investor(s) over the activities of the joint venture. Specifically, APB Opinion No. 18 addresses financial accounting and reporting by investors in business enterprises. A governmental unit with significant investments in joint ventures, particularly if debt has been issued by the sponsoring government to finance the investments, should consider reporting its investment in the joint venture directly in its financial statements to avoid apparent decapitalization of its financial position. Decapitalization occurs if the joint venture debt is reported by the sponsoring government, but no related assets are recorded. If the assets of the joint venture are principally fixed assets, the investment may be reported in the general fixed assets account group; in other situations, the investment may be reported in "enterprise funds."

Special Units of Government

15.10 *Colleges and Universities.* Governmental colleges and universities should follow the guidance in chapter 5 of this guide. Under GASB Cod. sec. 2600.109, those activities may be reported as a discrete "university fund type."

15.11 *Hospitals.* Hospitals generally should be reported as enterprise funds according to the AICPA *Hospital Audit Guide*, as discussed in chapter 13.

15.12 *School Districts.* School districts are the most frequently encountered special units. In some states, school districts operate as an integral part of a local governmental entity; but in others, school districts are independent units. School districts' boundaries may or may not be coterminous with a political subdivision. Regardless of whether school districts are component units of other reporting entities, joint ventures of several reporting entities (such as some of the so-called consolidated districts), or meet the definition in GASB Cod. sec. 2100 as separate reporting entities, many school districts prepare separate financial statements, for the following reasons:

- A school district needs its own financial report to support state or federal aid applications.
- A school district desires to report financial activities to parent, teacher, taxpayer, and citizen groups.
- A school district may enter into its own financing arrangements and thus be obliged to prepare a financial report for use in an official statement.

15.13 There are several unique aspects of school districts, such as the following:

- *Attendance reporting*—Most school districts receive state aid on the basis of average daily membership (ADM) or average daily attendance (ADA). ADM and ADA data are typically determined at individual schools and reported to a central attendance unit. That unit prepares reports for state aid and, in many cases, for federal aid, such as impacted area aid. Attention should be directed to attendance reporting in light of its importance to overall revenues of the school district. Incorrect attendance reporting can lead to receipt of too much or too little aid.
- *Student activity funds*—Most school districts have cash funds or bank accounts at individual schools under control of school principals, principally student-generated monies. Attention should be directed to such funds, which are frequently excluded from the entity's normal accounting records and controls.
- *U.S. Department of Education Requirements*—The Department of Education has issued *Financial Accounting for Local and State School Systems*, which suggests a standardized chart of accounts for school districts. That publication is widely followed because financial reporting under, and applications for, federal grants generally require its approach. The auditor should be familiar with

Financial Accounting for Local and State School Systems or state mandated variations of it.

- *School lunch programs*—Most school districts participate in the U.S. Department of Agriculture (USDA) free or reduced price food programs. The auditor should be familiar with the USDA's regulations for such programs. The USDA-donated commodities may also pose accounting and reporting problems; generally they are reported as revenue when received.

15.14 State level departments of education as well as the Association of School Business Officials have also issued a number of helpful publications on school system management.

15.15 *Housing Authorities.* Housing authorities provide shelter to lower income citizens and generally receive substantial capital and operating grants from the U.S. Department of Housing and Urban Development. Housing authorities also may finance low-interest mortgages for citizens and engage in urban renewal activities. Some housing authorities operate on a regional basis and, in effect, as joint ventures.

15.16 If the criteria for proprietary funds are met, housing authorities should be reported as enterprise funds. Otherwise, they should be accounted for as governmental funds. The auditor should be familiar with the various housing grant programs in undertaking an audit of a housing authority.

15.17 *Financing Authorities.* Many governmental units have established financing authorities to provide resources for specific capital projects or loans to special interest groups, such as organizations of veterans or farmers. Some financing authorities are established for the benefit of other governmental units or nonprofit organizations, for example, a government-supported hospital financing authority. In some cases, a for-profit business organization is the beneficiary of a financing authority, for example, an economic development authority that issues industrial revenue bonds, the proceeds of which are used to provide for plant expansion, and so forth, and thereby increase a community's employment and tax base. In other cases, a financing authority may be created by a governmental unit solely to finance internal capital projects, such as university dormitory construction. As a further example, mortgage financing authorities make low-interest mortgage loans to citizens.

15.18 Typically, a financing authority issues bonds to obtain funds for the construction of a facility that is then leased to another government or private sector organization. Lease payments received are used to service the bond principal and interest, and the ownership of the facility transfers to the lessee when the bonds mature and are retired. In some cases, financing authorities develop a permanent capital base used to make loans and, occasionally, grants.

15.19 Authorities that make loans to citizens or citizen groups typically service bond principal and interest from loan repayments. Interest income in excess of interest expense typically finances administrative costs.

15.20 A financing authority generally should be classified as an enterprise fund or as a nonexpendable trust fund within the fiduciary fund type.

15.21 Some authorities, such as economic or industrial development agencies, are created solely to lower the cost of borrowing for private sector entities constructing facilities within the jurisdiction served. The authority does not become involved in the construction activities or in repayment of the debt. Debt service is usually administered by a financial institution. In such cases, the debt and related capital lease receivable should normally not be recorded in the financial statements of the government unless the government authority or other component unit of the government has responsibility for repayment in the event of default. Fees charged to the entities benefiting from the debt issuance and administrative expenses of the authority should be reported in the operating statement of the authority. The financing debt and related capital leases outstanding in which the government has participated should be disclosed in footnotes to the financial statements of the sponsoring government with a clear indication that the government has no responsibility for repayment.

15.22 Governmental units that create authorities to finance their capital projects usually execute lease contracts between the governmental units and the financing authorities. In the general purpose financial statements of the governmental unit the financing authority lease contract receivable should be offset against the lease liability of the governmental unit. Other transactions and balances of the authority should be combined with the activity of the government fund making the lease payments. The outstanding long-term debt of the authority should be reported in the general long-term debt account group and related fixed assets reported in the general fixed assets account group. Similarly, if intercomponent unit leasing occurs, the effects of the interentity lease and debt should be eliminated. Further reporting guidance is provided in GASB Cod. sec. L20.

15.23 *Transportation Systems.* Transportation systems may be operated either by independent regional authorities or may operate as joint ventures of the participating governments or as component units of individual governmental units. Most transportation systems are accounted for as enterprise funds (see Cod. sec. 1300.104b(1)).

15.24 Most public transportation systems, because of low rates or low ridership, must seek outside contributions to finance facilities, equipment, and operating expenses. Net income, nevertheless, should include charges for depreciation on assets acquired from contributions in aid of construction as well as those acquired with internal resources. Though depreciation expense on all assets is included in the statement of revenues and expenses to determine the net income or loss resulting from the operation of the system, the amount applicable to assets acquired from capital grants may be closed to the related contributed capital account rather than to retained earnings. The support for that treatment is set forth by GASB Cod. sec. G60.

Chapter 16

State Governments

16.1 Though the matters discussed in the previous chapters generally apply to state governments, there are several areas that are somewhat peculiar to state governments. The first is that they generally are large operations. Other distinguishing aspects include the following:

- Reporting entity
- Aid to local governments
- Pass-through monies
- State lotteries
- Medicaid
- Income and other taxes
- Jurisdictional concerns

Though those areas may also be of concern in audits of local governments, they are more commonly associated with state governments.

Nature of States

16.2 State governments differ from local governmental units by having sovereign power. States have powers of action limited by their individual constitutions and the powers reserved exclusively to the federal government by the Constitution of the United States and the rights guaranteed to citizens by amendments to that constitution. States can enact, repeal, and modify statutes relating to the conduct of economic, political, social, and individual activities subject to those limitations. All other governing bodies within the state exist as consequences of general or specific authorizations from the state government and are accorded only those powers provided for in such authorizations. State governments have implicit power, while subordinate governments created by states generally are limited to the powers expressly provided to them by the states or not expressly reserved for the state and, in some cases, not expressly prohibited.

16.3 To meet the varying needs of citizens, the states have established a variety of forms of state agencies and departments, regional governments, and local governments. The extent and nature of those organizations affect the structure of the state financial reporting entity and thus the audit approaches needed.

16.4 To deal with the problems inherent in the variety of organizational structures, most states have established accountability centers, usually under the control of state comptrollers or treasurers. Such accountability centers do not normally maintain accountability for all the component units of the state oversight entities. Rather, such centers are often limited to responsibility for the funds and activities of the states from which appropriations are made to departments and agencies. Other component units, such as public benefit corporations and authorities, in many instances maintain their own accounts and manage their own financial affairs, either with or without oversight from the accountability centers.

Accounting Considerations

16.5 GASB statements and interpretations are also applicable to state government financial statements. Financial statements of states should comply with those standards and any subsequently issued GASB pronouncements.

16.6 In addition to GASB statements and interpretations, the research report issued jointly by the Council of State Governments and the NCGA, *Preferred Accounting Practices for State Governments* (PAPSG), describes preferred accounting practices for states. In September 1977, the Council of State Governments began working toward the achievement of the following two major objectives:

1. To determine the current accounting principles and reporting practices used in each of the states
2. To analyze the findings and develop from them a set of relevant and acceptable accounting principles and reporting practices for state governments

16.7 In November 1980, the Council of State Governments achieved the first objective of PAPSG with the publication of its

Inventory of Current State Government Accounting and Reporting Practices.

16.8 PAPSG compared the results of that inventory with NCGA pronouncements. Based on the results, issues papers were developed that evaluated the alternative accounting treatments and recommended courses of action for each issue. The issues papers were exposed for public comment, and the comments were analyzed and used in revising the issues papers. In February 1982, the Council of State Governments and the NCGA jointly sponsored the publication of the issues papers as an exposure draft of the PAPSG research report to solicit additional input from interested parties before finalizing the report.

16.9 In February 1983, the Council of State Governments achieved the second objective with the publication of the final PAPSG research report with only minor changes from the original exposure draft.

16.10 Though the research report is not binding, it does provide a useful source of information and the best current thinking on accounting and reporting in areas not specifically addressed in GASB statements and interpretations or FASB pronouncements. Further, PAPSG's research report has been widely accepted by the states.

16.11 Nevertheless, there are state-mandated accounting and reporting requirements that differ from GAAP. They generally come from statutes, and their existence and specifics should be ascertained and confirmed by discussions with representatives of the states' attorneys general, treasurers, comptrollers, and auditors. For example, certain additional financial summaries may be legally mandated to be prepared and published.

Auditing Considerations

16.12 In addition to the areas discussed in the previous chapters, the following auditing issues should be considered in conducting audits of state governments.

Reporting Entity

16.13 Determining the state reporting entity is often difficult due to the diversity of state component units, extensive use of nearly autonomous component units, such as public benefit corporations, and decentralized accounting systems. The problems may be even more complicated if significant numbers of component units are required to be included in the state reporting entity. The diversification in operations of states often requires the independent auditor to be knowledgeable about industries other than those conducted by local governments, such as utilities, transportation, higher education financing, and health care. Chapters 1 and 5 discuss considerations associated with accounting and reporting under GASB Cod. sec. 2100.

Aid to Local Governments

16.14 States provide aid to local governments in the form of shared revenue, such as sales or highway taxes; grants similar to federal matching grants; and entitlements, such as state school aid based on enrollment. Aid is distributed to local governments based on a formula, eligibility criteria, or both.

16.15 The auditor should consider whether the formula and eligibility criteria are being properly applied and consider the internal accounting controls surrounding the awarding, monitoring, and payment functions. In addition, the auditor should determine the reasonableness of amounts recorded as payable to the local governments under the requirements of the various programs. Many programs operate on a reimbursement basis, and the state thus does not know the actual amount owed until after year-end when local governments report reimbursable claims. Such amounts, therefore, frequently require management estimates.

16.16 The auditor should determine that the amounts payable to the localities for shared revenues are properly accrued and reported in the financial statements. The auditor should consider reviewing disbursements subsequent to year-end to gain assurance that all such liabilities have been accrued. Additionally, the auditor should ascertain the existence of state receivables resulting from advance payments made to local governments or disallowed expenditures made by local governments.

Pass-through Monies

16.17 States often act as pass-through agents for federal funds allotted to states for programs administered by local governments, either as consequences of federal legislation or decisions of the states. Many social service programs, such as aid to families with dependent children and Medicaid, are financed in that manner.

16.18 The auditor should consider whether the monies are administered in accordance with the conditions specified by the federal government. The auditor should consider the extent to which the state passes through its accountability and legal responsibilities related to the pass-through monies. If accountability is shifted to the recipient, then minimal audit work generally is necessary. If a state retains some degree of accountability, the auditor should consider whether the state has procedures to determine that the monies are spent properly by local recipients. If the state is allowed to receive fees for administering the programs, the auditor should determine that the state received the proper amounts.

16.19 The federal government may disallow expenditures not in accordance with the assistance agreement. If the risk of refund to the federal grantor is not effectively passed through to local recipients, there may be a need to establish an allowance for refunds. Federally mandated pass-through monies are generally reported as agency fund transactions if the state is merely a conduit, or in general or special revenue funds if the state may elect to pass monies through to localities. The auditor should ascertain that the proper fund and account classifications of pass-through monies are used. Finally, the auditor should consider whether the state has a liability, or a contingent liability, for not disbursing the monies in accordance with federal requirements. For a further discussion of this, see chapter 21.

Lotteries

16.20 A growing number of states and some local governments are using lotteries to supplement revenues. Lottery revenue should be matched with proportionate shares of prize costs and, accordingly, both revenues and prize and other costs should be accounted for on an accrual basis, normally in an enterprise fund. Such prizes may be lump-sum payments, annuities, or both. The auditor should consider whether liabilities have been properly recorded for prizes won but not awarded and amounts to be awarded for games in progress at year-end.

16.21 Large prizes typically are paid over a period of years. The liability for such prizes is often financed with an annuity purchased from a private insurance company. When the purchased annuity is in the name of the prize winner, no liability or asset is recognized by the government because it has discharged the primary liability. However, consideration should be given to whether a contingent liability exists that should be disclosed in the financial statements. If an annuity in the name of the prize winner is not purchased, the liability and any specifically identified assets should be included in the financial statements of the governmental unit. The liability should be recorded at its present value.

16.22 Some games, such as Lotto, may provide for a cumulative prize over time and a split of the total prize. In those situations, policies usually are established that provide for variable payout periods depending on the size of the amount awarded to each individual. For such games in progress at year-end, it is necessary to record an estimate of the present value of anticipated prizes. In making that estimate it is necessary to consider the possibility of multiple winners and the resulting effect of any related shorter payout period on the present value computation.

16.23 Lottery tickets are generally sold in stores and other designated locations throughout the state. Management should estimate the amount of receivables due from the sale locations along with an allowance for doubtful collections from sales agents to whom tickets have been consigned. The auditor should evaluate the reasonableness of those estimates.

Medicaid

16.24 Medicaid services may be administered by states or through local governments on behalf of the states. In either event, health care providers (for example, hospitals, physicians, nursing homes, pharmacies, and so forth) are required to follow guidelines established by the state. Various methods and formulae are used to reimburse providers (and as necessary, local governments) for services rendered.

- Hospitals and nursing homes may be reimbursed "costs" of rendering the services, with costs based on retrospective cost reports filed by the provider.
- Hospitals and other providers may be paid a predetermined (prospective) amount for each service rendered, based on the nature of the service, its complexity, or both.
- Non-hospital providers may be reimbursed based on the cost of the service (physician office visit, prescription, and so forth) up to a maximum cost per service.
- Other reimbursement methods may be used for various providers.

At times, the state may make interim payments to providers, particularly hospitals, during the year based on interim reports. Settlements may be made at year-end, based on audited cost reports. Those settlements can be either receivables from or payables to the providers.

16.25 In many cases, providers or local governments may make claims for payments well after year-end. Because of timing problems, the state may have to estimate the year-end liability to, or receivable from, providers. The auditor should consider whether payables and receivables, and related expenditures and revenues, are properly estimated and recorded at year-end. Because these accruals are based on services rendered before year-end, the auditor may have to use historical information to ascertain the reasonableness of the receivable or payable.

Income Taxes

16.26 Many governments assess income taxes. Corporate or individual taxpayers make estimated payments during the year and file returns, usually by April 15 for individuals and an earlier date for corporations, to establish the amounts of their tax liabilities.

16.27 The amounts of the liabilities are not known by the state until the returns are filed. No matter what the fiscal year-end of the state is, there is generally an estimated payable to, or receivable from, taxpayers as a group. States generally estimate the amounts based on historical experience. Advanced mathematical and statistical techniques, such as regression analysis, may be necessary to help estimate the amounts. The auditor should determine the reasonableness of the estimation process and the resulting amount.

16.28 It is usually not possible to establish conclusively whether all individuals and entities are paying all of the income taxes due. However, the auditor should consider whether reasonable efforts are being made to keep non-payers to a minimum. In that connection, the auditor should consider the internal accounting controls surrounding the collection of current and delinquent income taxes; methods used for determining population completeness, frequently referred to as "enforcement" or "discovery" (for example, are all citizens filing income tax returns?); and the audit and follow-up processes related to income tax returns.

Jurisdictional Concerns

16.29 State governments generally consist of three branches: legislative, executive, and judicial. Conflicts often exist among the branches regarding responsibilities and authority. As a practical matter, the auditor should be aware of such possible conflicts and consider whether the appropriate individuals are included in planning the audit, advised of audit progress, and provided opportunities to respond to draft reports.

16.30 The legislative and judicial branches may maintain their own accounting systems. The auditor should be cognizant of the possibility of numerous systems of internal accounting control and should determine the extent to which such systems need to be evaluated for their effects, if any, on audit procedures.

Chapter 17

Federal Financial Assistance Program Auditing

17.1 Since the end of World War II, the federal government has become increasingly involved in providing financial assistance to state and local governments through a wide variety of programs. Similarly, state governments have increasingly provided financial assistance to their political subdivisions. One reason is limited revenue sources available to local governments and the trend for higher level governments to mandate programs that must be administered by local governments. Included are a wide variety of programs in areas such as welfare, medical care, and unemployment.

17.2 In addition, certain capital spending programs that result from mandates to comply with federal standards and regulations have required federal financial assistance to assure their implementation. Examples are programs for sewage treatment, highway construction and maintenance, and rapid transit.

17.3 As a result, federal expenditures involved in such assistance programs, as well as the number of programs administered by the various federal agencies, have increased significantly. In 1984, assistance programs had total expenditures of $97.2 billion. The growth of such expenditures over the years is shown in the following table.

Year	Total Federal Assistance ($millions)
1955	$ 3,207
1965	10,904
1975	49,834
1984	97,209

17.4 Federal financial assistance may take the form of grants, contracts, loans, loan guarantees, property, cooperative agreements, interest subsidies, and insurance or direct appropriations. Though grants are the form most frequently encountered by auditors, auditors should determine whether recipient governments have received other forms of federal financial assistance and plan and conduct their audits accordingly.

Types of Grant Programs and Reimbursements

17.5 There are a number of distinct types of grant programs. Grant proceeds may be paid to governments under reimbursement arrangements in which the recipient government bills the grantor for costs as incurred. Other grants provide for advance payments or permit the government to draw against letters of credit as grant expenditures are incurred.

17.6 Certain grants provide for co-funding or matching funds with the federal government, in which the participating state or local government bears a percentage of the total costs of a program. Grants may be further classified as follows.

17.7 *Categorical Grants.* Categorical grants provide funds for specific programs and activities. In the past, most grants were of this kind. Recently, block grants, which provide more discretion in the use of funds, have been used.

17.8 *Block Grants.* Block grants generally combine a wide range of activities previously supported by a number of categorical grants. The Community Development Block Grant Program of the Department of Housing and Urban Development is an example.

17.9 *Entitlements.* Entitlements are funds provided on a formula basis, usually based on demographic characteristics of the government. Revenue sharing is an example of this type of grant.

17.10 For accounting purposes, grants may be further classified into two types:

- *Operating grants*—Operating grants are provided to support all or a portion of current operating expenses.
- *Capital grants*—Capital grants are restricted for use to acquire or construct fixed assets.

Auditing Considerations

17.11 An auditor may be engaged to perform—

- An audit of the general purpose or basic financial statements of the entity that includes grantor assistance activity, but no separate report on grant or other federal financial assistance is required.
- An audit in accordance with the Single Audit Act of 1984, P.L. 98-502 and Office of Management and Budget (OMB) Circular A-128, *Audits of State and Local Governments*, which requires an audit of the general purpose or basic financial statements of the entity and additional compliance, internal control, and other audit and reporting relating to federal financial assistance programs.

Audits of the General Purpose or Basic Financial Statements—No Separate Report on Grant or Federal Financial Assistance

17.12 The auditor should consider the following audit tests with respect to significant federal or state assistance programs when performing an examination of the financial statements when no separate report on grant or other federal financial assistance is required:

- Examining and obtaining an understanding of grant documents and programs, including scope of services, eligibility requirements, and matching fund requirements
- Determining how officials responsible for administering programs make sure that the organization is complying with specific requirements of assistance agreements
- Evaluating financial reporting practices related to programs:
  - Reviewing the procedures used to accumulate and document expenditures for which reimbursement is expected to be claimed, including those used to (a) accumulate costs that are either fully or partly funded by the program, (b) identify allowable services that are reimbursed on a fixed-charge basis, and (c) document eligibility of beneficiaries for benefits under the programs
  - Evaluating the timeliness and accuracy of reporting provided to the grantor
  - Reviewing the procedures for draw-downs for assistance programs operating under letters of credit

- Determining whether any material questioned costs exist, such as costs that may be determined to be unallowable because they were not incurred in compliance with the assistance agreements and related regulations, including documentation requirements
- Confirming with the grantors the existence of assistance agreements, significant terms, costs reported and reimbursements requested or drawn down, and the current status of program reporting
- Testing the accrual of reimbursements requested but not received and the recording as deferred revenue the reimbursements that have been received before reimbursable costs have been incurred
- Testing other specific compliance matters included in the assistance agreements

17.13 If a state or local governmental unit has incurred contingent liabilities relating to its failure to comply with assistance requirements for the year under audit or a prior fiscal year, consideration should be given to recording or disclosing such liabilities in the financial statements. Guidance in that area is provided by FASB Statement No. 5, *Accounting for Contingencies*, FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, and GASB Cod. sec. C50 and C60, *Accounting and Financial Reporting for Claims and Judgments and Compensated Absences*. This area is also discussed in chapter 10.

The Single Audit — An Overview

17.14 The remainder of this chapter provides an overview of the requirements of the Single Audit Act and OMB Circular A-128. Auditors should refer to part VII of this guide for further guidance on planning, conducting, and reporting on audits conducted in accordance with such requirements. This guide and the guidance provided have been developed in consultation with representatives of the OMB, GAO, and the Inspectors General.

17.15 Before 1979, the scope of a federal grant audit was usually limited to an examination of the financial statements of individual federal award programs, grants, or other federal financial assistance, and a test of the recipient's compliance with the terms of individual federal financial assistance agreements. Each federal agency established its own audit guidelines and the specific reports to be filed for its own programs. No single agency was responsible for oversight of all federal financial assistance awarded to a single recipient organization. As a result, in many instances, the same internal accounting control systems and transactions were subjected to numerous reviews and tests, and frequently the recipient organization was audited by different groups simultaneously. The Single Audit Act, enacted in 1984, substantially revised the government's approach to auditing federal financial assistance.

17.16 The Single Audit Act reoriented the focus of attention on a single coordinated audit of the aggregate federal financial assistance provided to a recipient government during each of its fiscal years, with special emphasis on defined major federal financial assistance programs. The audit requirements of the Single Audit Act are administered on behalf of the federal government by cognizant agency representatives who are designated or agree to represent the collective interests of the federal government. The requirements include an audit of the entity's general purpose or basic financial statements, the performance of additional audit tests for compliance with applicable laws and regulations, and reviews of federal financial assistance program internal control systems. The terms *single audit*, *organizationwide audit*, and *entitywide audit* are frequently used synonymously by practitioners in reference to the more coordinated, and as a result, more comprehensive form of federal financial assistance auditing required by the Single Audit Act and OMB Circular A-128.

17.17 The Single Audit Act is reproduced in Appendix D of this guide. It applies to state or local governments with respect to any of their fiscal years that begin after December 31, 1984.
The objectives of the Act are—

- To improve the financial management of state and local governments with respect to federal financial assistance programs through improved auditing.
- To establish uniform requirements for audits of federal financial assistance provided to state and local governments.
- To promote the efficient and effective use of audit resources.
- To ensure that federal departments and agencies, to the maximum extent practicable, rely on and use audit work performed pursuant to the requirements of the Single Audit Act.

17.18 Though the single audit builds on the annual financial statement audit currently required by most state and larger local governments, it places substantial additional emphasis on the study and evaluation of internal controls and the testing of compliance with laws and regulations. The nature of this emphasis is central to an understanding of the Single Audit Act.

17.19 The provisions of the Single Audit Act do not limit the authority of a federal agency to conduct or contract for additional audits of a recipient organization. However, the Single Audit Act provides that any additional audit work should not duplicate the work already performed. Further, federal agencies contracting for additional audit work are responsible for the additional costs involved.

OMB Circular A-128

17.20 On April 12, 1985, OMB issued Circular A-128, *Audits of State and Local Governments,* which superseded Attachment P to Circular A-102. It was issued to facilitate the implementation of the Single Audit Act of 1984, P.L. 98-502, and establishes specific audit requirements for state and local governments that receive federal financial assistance. Also, it defines federal responsibilities for implementing and monitoring those requirements.

17.21 The single audits are to be conducted by independent auditors who are defined as—

- External state or local government auditors who meet the independence standards included in the Standards for Audit issued by the GAO.
- Public accountants who meet the GAO independence and qualification standards.

17.22 As required by the Single Audit Act and Circular A-128, single audits are to be conducted in accordance with the standards set forth in the financial and compliance elements of the Standards for Audit issued by the GAO. Those standards incorporate the AICPA Statements on Auditing Standards for field work and reporting and, in several cases, establish additional requirements, particularly with respect to internal control and compliance reviews and reports.

Audit Requirements

17.23 The audit requirements of the Single Audit Act and Circular A-128 apply to each state and local government that receives a total amount of federal financial assistance of—

- $100,000 or more in any of its fiscal years, or

- $25,000 or more, but less than $100,000 in any fiscal year, if it elects to implement the Single Audit Act requirements in lieu of separate financial and compliance audit requirements of the federal financial assistance programs.

17.24 If a government receives less than $25,000 in any fiscal year, it is exempt from the audit requirements of the Single Audit Act and all other federal audit requirements.

Audit Period

17.25 If a state or local government's constitution, statute, or its administrative rules, regulations, guidelines, standards, or policies require audits less frequently than annually, the Single Audit Act provides that the cognizant federal agency shall, on request of such government, permit the government to conduct biennial audits, which cover the activities of both years. However, after December 31, 1986, such audits must be made annually unless the recipient government codifies in its constitution or statutes a requirement for biennial audits.

Scope of Covered Activities

17.26 The Single Audit Act and OMB Circular A-128 require the auditor to determine whether—

- The financial statements of the government, department, agency, or establishment present fairly its financial position and the results of its financial operations in accordance with GAAP.
- The organization has internal accounting and other control systems to provide reasonable assurance that it is managing federal financial assistance programs in compliance with applicable laws and regulations.
- The organization has complied with laws and regulations that may have a material effect on its financial statements and on each major federal financial assistance program.

17.27 The Single Audit Act requires that single audits conducted "for any fiscal year shall cover the entire state or local government's operations except that, at the option of such government, such audit may . . . cover only [audit separately] each department, agency, or establishment which received, expended, or otherwise administered federal financial assistance during such fiscal year." (See sec.

7502 of the Single Audit Act.) However, a governmental unit that receives a total of $25,000 or more in *general revenue-sharing assistance* does not have the option of having a single audit conducted of only a department or agency that administered federal financial assistance. Such recipients must have an audit conducted of their entire operations which are included in their general purpose or basic financial statements. The Single Audit Act also provides that a series of audits of individual departments, agencies, and establishments for the same fiscal year may be considered a single audit. The audit may exclude public hospitals and public colleges and universities. However, if such entities are excluded, audits of those entities shall be made in accordance with statutory requirements and the provisions of OMB Circular A-110, *Uniform Requirements for Grants to Universities, Hospitals, and other Nonprofit Organizations.*

Reporting Requirements

17.28 The Single Audit Act and Circular A-128 require the auditor to issue for the entity—

- A report on an examination of the general purpose or basic financial statements of the entity as a whole, or the department, agency, or establishment covered by the audit.
- A report on internal accounting control based solely on a study and evaluation made as a part of the audit of the general purpose or basic financial statements.
- A report on compliance with laws and regulations that may have a material effect on the financial statements.

17.29 The Single Audit Act and Circular A-128 require that the auditor include, for the entity's federal financial assistance programs—

- A report on a supplementary schedule of the entity's federal financial assistance programs, showing total expenditures for each federal financial assistance program.
- A report on internal controls (accounting and administrative) used in administering federal financial assistance programs.
- A report on compliance with laws and regulations identifying all findings of noncompliance and questioned costs.
- A report on fraud, abuse, or an illegal act, or indications of such

acts, when discovered (a written report is required); normally, such reports are issued separately.

17.30 Except for the following discussion of the applicability of GAAP, all other audit and reporting considerations associated with the issuance of those reports related to the entity are discussed in other chapters of this guide. The federal financial assistance program audit and reporting considerations are discussed further in chapters 21 and 22. Chapter 23 discusses formats for meeting those reporting requirements.

Applicability of GAAP

17.31 Sec. 7502 of the Single Audit Act requires the auditor to express an opinion as to whether the financial statements of the governmental unit as a whole are fairly presented in conformity with GAAP. However, for various reasons such as legal or regulatory requirements, some state and local governmental units prepare their financial statements on a basis of accounting other than GAAP (for example, cash basis). If financial statements are prepared on a comprehensive basis of accounting other than GAAP, the auditor's report should be prepared in accordance with SAS No. 14, *Special Reports*, which requires the report to (1) state, or refer to a note to the financial statements that states, the basis of presentation and (2) refer to a note to the financial statements that describes how the basis differs from GAAP. Further, the auditor's report should state that the financial statements are not intended to be presented in conformity with GAAP.

Failure to Follow Government Audit Standards

17.32 The auditor should be aware that AICPA Ethics Interpretation 501-3, "Failure to Follow Standards and/or Procedures or Other Requirements in Governmental Audits," states that when an auditor undertakes a governmental engagement and agrees to follow specified government audit standards, guides, procedures, statutes, rules, and regulations, the auditor is obligated to follow those standards or guidelines in addition to GAAS. Failure to do so is an act discreditable to the profession in violation of rule 501 of the AICPA Code of Professional Ethics unless it is disclosed in the auditor's report that those rules were not followed and the reasons therefor. Chapters 21 through 23 identify additional auditor responsibilities and considerations under the Single Audit Act and OMB Circular A-128 and the Standards for Audit issued by the GAO and, accordingly, auditors should refer to those chapters for additional guidance.

17.33 The most significant additional requirements of the Standards for Audit issued by the GAO as compared to GAAS relate to the requirement to issue an auditor's report on compliance with laws and regulations and the requirement for additional disclosures in the auditor's report on internal controls. Reports that conform to those requirements are discussed in chapter 23. In addition, Standards for Audit issued by the GAO provides additional guidance in certain areas with which the auditor should be familiar. Those areas include working paper requirements, the reporting of fraud, abuse, and illegal acts, and certain requirements dealing with the tone, tenor, and form of presentation of reports.

State Audit and Grant Compliance Requirements

17.34 Many states also make grants to their political subdivisions and, as does the federal government, prescribe audit requirements. In conjunction with the general purpose or basic financial statement examination, the auditor should obtain an understanding of applicable state reporting and compliance requirements. If engaged to audit state grant activity, the auditor should also obtain an understanding of any special auditing requirements prescribed by the state.

17.35 When the auditor is engaged to perform an individual grant audit on behalf of a state agency, the auditor should consider the following steps:

- Obtain any applicable audit guidance from the grantor agency.
- Confirm with the grantor agency that any audit guides expected to be used contain all amendments, administrative rulings, and the like, pertaining to the grant.
- Discuss and obtain agreement with the agency on the scope of testing that is expected to be performed.

17.36 Though the Single Audit Act does not address auditing state grant compliance requirements, state assistance may be so included at the option of the local government or if required by state law. In those circumstances auditors should consult state officials or other sources concerning the nature and scope of testing they require. However, state assistance provided to local recipients with state funds must be distinguished from state pass-through of federal funds. The latter pass-through funds, further discussed in chapter 22, are considered part of the federal financial assistance received by the local recipient when conducting an audit in accordance with the Single Audit Act and OMB Circular A-128.

Part V
Auditors' Reports

Chapter 18

Auditors' Reports on Basic or General Purpose Financial Statements

18.1 Many governmental units are required by law to publish annual financial reports. An increasing number of such reports contain financial statements that have been examined by independent auditors. The governmental unit is responsible for the contents of its financial statements, including the notes. The independent auditor's responsibility is to report on the financial statements. The type of report the independent auditor issues depends on the contents of the financial statements and on the scope and results of the auditor's examination. Appendix A presents examples of auditors' reports.

Levels of Financial Reporting

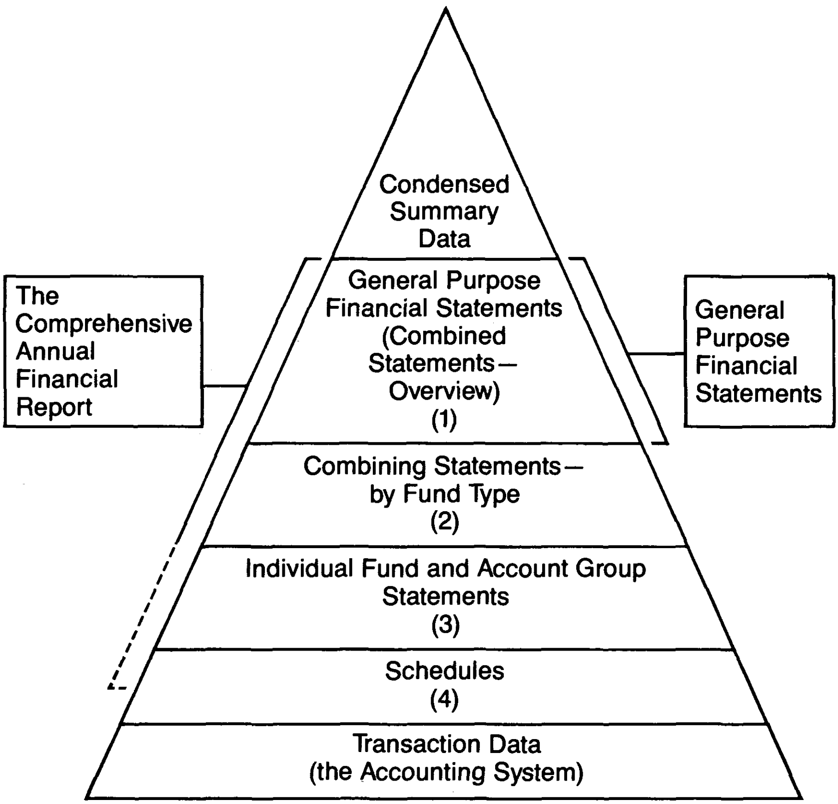
18.2 The NCGA developed a financial reporting "pyramid," which characterizes financial reports of governmental units (see Exhibit 18-1). The pyramid approach to governmental financial statements has implications for the nature and scope of financial audits.

18.3 Before NCGA Statement 1 was issued, fair presentation of financial information of governmental units in conformity with GAAP consisted of financial statements for individual funds. NCGA Statement 1 changed the financial reporting focus from individual funds to combined financial statements that show fund types and account groups.

18.4 Combined financial statements in governmental financial reporting are significantly different from combined financial statements in commercial financial reporting. In the commercial area,

Exhibit 18-1

The Financial Reporting "Pyramid"



— Required
--- May be necessary
( ) Refers to "The Financial Section 'Pyramid'" discussion

Source: NCGA Statement 1.

combined financial statements generally are *consolidated* financial statements for two or more business enterprises that do not have a parent-subsidiary relationship. In the governmental area, combined financial statements show the respective fund types and account groups in side-by-side columns. Examples of combined financial statements are included in GASB Cod. sec. 2200.601.

18.5 GASB Cod. sec. 1900.108 recommends financial reporting on two levels. The first level is financial statements for each fund type and for both account groups, which are presented in columns on the "general purpose financial statements" (GPFS). The second level is the "comprehensive annual financial report" (CAFR). A financial report must include prescribed combining and individual fund financial statements, schedules, and statistical tables to meet the requirements of a CAFR. However, a government may issue a report that includes more financial information than is required by a GPFS but less than that required by a CAFR. In any event, care should be exercised to assure that the terms of the engagement clearly define the level of financial statements to be examined and reported on.

18.6 As discussed in various chapters of this guide, the GPFS and CAFR of a reporting entity as defined in GASB Cod. sec. 2100 should include the financial statements of component units. The auditor should perform procedures to be assured that all of the reporting entity's component units are so included. The auditor may examine ordinances, interview officials, and make other inquiries to evaluate whether there are component units that should be, but have not been, included in the reporting entity according to the provisions of GASB Cod. sec. 2100. Moreover, the auditor also should determine if includible components have been audited and, if so, also refer to SAS No. 1, section 543, and chapter 5 of this guide for further guidance. If the organizations have not been audited, it may be necessary to request that the client arrange for an audit.

Financial Statements

General Purpose Financial Statements

18.7 GASB Cod. sec. 2200.126 states "The fund type and account group financial information included in the...GPFS...constitutes 'fair presentation in conformity with generally accepted accounting principles.'" The following are the GPFS discussed and illustrated in GASB Cod. sec. 2200:

- Combined balance sheet—all fund types and account groups
- Combined statements of revenues, expenditures, and changes in fund balances—all governmental fund types
- Combined statements of revenues, expenditures, and changes in fund balances—budget and actual—general and special revenue fund types (and similar governmental fund types for which annual budgets have been legally adopted)
- Combined statement of revenues, expenses, and changes in retained earnings (or equity)—all proprietary fund types
- Combined statement of changes in financial position—all proprietary fund types and similar trust funds
- Notes to financial statements

18.8 The combined financial statements listed above should include all disclosures necessary for fair presentation in conformity with GAAP. GASB Cod. sec. 2300 provides guidance on disclosures.

18.9 The GPFS may present *total* columns aggregating the amounts presented in the fund type and account group columns. If a total column is presented, it should be captioned "Memorandum Only" because the total column is not comparable to consolidated financial statements. A note to the financial statements should indicate that the column is presented for information only, disclose whether interfund balances and transactions have been eliminated, and state that the column does not present consolidated financial information.

18.10 *Consolidated Financial Statements.* Some governmental units have issued consolidated statements that present only a single column and include all eliminations normally associated with commercial consolidated financial statements. The question of whether such consolidated financial statements are more meaningful than combined financial statements is under study. Current accounting literature requires combined financial statements for fair presentation in conformity with GAAP and considers consolidated financial statements supplementary data.

18.11 *Budgetary Comparisons as Part of Financial Statements.* GASB Cod. sec. 1700 requires that governmental financial reports include comparisons of the final amended budgeted amounts with actual results of operations on the budgetary basis. Such comparisons are required for the general, special revenue, and other governmental fund types for which annual budgets are legally adopted.

18.12 If annual budgets are adopted for some but not all funds of a particular governmental fund type, data should be presented only for those funds with annual budgets.

18.13 If the budget is prepared on a basis that differs from GAAP, GASB Cod. sec. 2400 requires the actual information to be presented on the budget basis in the combined statement of revenues, expenditures, and changes in fund balance—budget and actual, general and special revenue fund types. The nature of the reconciling items between GAAP and the budget basis should be disclosed in the notes to the financial statements as outlined in GASB Cod. sec. 2400.104. Accounting and reporting for encumbrances is a common example of such a reconciling item. GAAP requires encumbrances outstanding at year end to be reported as reservations of fund balance and not as expenditures. Budgets, however, often treat encumbrances as expenditures. Additional guidance on budget-GAAP differences is provided in GASB Cod. sec. 2400.

18.14 *Legal Budgets Exceeding One Year in Length.* Some governmental units control spending for particular programs or projects by adopting legal budgets that include more than one year's expected expenditures. For example, legally authorized budgets for capital projects are often adopted for the multi-year lives of the projects. Such budgets are not required to be presented in the GPFS.

18.15 *Legally Required Proprietary Fund Budgets.* Though GAAP do not require the inclusion of budgetary comparisons for proprietary fund types, some jurisdictions may require such presentations by law. If so, budgetary comparisons for proprietary funds may be presented as supplementary information or in the GPFS.

Comprehensive Annual Financial Report

18.16 In addition to the combined financial statements, a governmental unit may also issue combining, individual fund, and account group financial statements and supporting schedules, usually in a comprehensive annual financial report. The auditor may report on the combining and individual fund financial statements either by themselves or as supplementary financial information.

Component Unit Financial Statements and Component Unit Financial Report

18.17 Only a reporting entity, as defined by GASB Cod. sec. 2100, may issue a GPFS or CAFR. However, as discussed in GASB Cod. sec. 2600, component units includible in a reporting entity, including the oversight unit, may issue "component unit financial statements" (CUFS) or a "component unit financial report" (CUFR).

Going Concern Uncertainties

18.18 SAS No. 34, *The Auditor's Considerations When a Question Arises About an Entity's Continued Existence*, deals with the auditor's considerations when a question arises concerning the recoverability and classification of recorded asset amounts and the amounts and classification of liabilities.

18.19 Many auditors have held the opinion that governmental units are not subject to the factors that might threaten the future existence of a business enterprise. That is largely attributed to the assumed power of governments to assess and levy taxes (and other charges) sufficient to finance operations and to service long- and short-term debt. However, the ability to generate revenues, though unlimited by law, can in fact be limited by the incomes and resources of taxpayers. Also, in recent years, governments have experienced instances in which local taxpayer initiatives have been enacted limiting governmental units' taxing powers. Other recent events and developments have also raised questions about the ability of certain governments to sustain operations. These include —

- Burdensome pension liabilities combined with shrinking populations and diminishing revenues.
- Cost escalation disproportionate to economic feasibility, for example, nuclear power plant construction.
- Unwillingness of senior governments to continue funding programs at existing levels.

18.20 Other factors to be considered include whether federal, state, or other local governments have a legal or moral responsibility to subsidize or otherwise provide financial support to a distressed unit of government. The auditor should consider those areas in evaluating the likelihood of default on debt, the inability to meet pension costs or other obligations, or the inability to financially support present operating levels.

The Independent Auditor's Report

General Concepts

18.21 *Generally Accepted Accounting Principles.* The primary objective of an examination of a governmental unit's financial statements by an independent auditor is the expression of an opinion on the fairness with which they present financial position, results of operations and, for its proprietary fund types, changes in financial position, in conformity with GAAP consistently applied. As discussed in chapter 5, the fund types and account groups are important elements of governmental financial statements and audit scope should be established and materiality evaluations should be applied at that level. Further, general purpose financial statements must present all applicable fund types and account groups in the governmental combined statement format in order to conform to GAAP.

18.22 *Financial and Compliance Audits.* An auditor performing an examination under the Standards for Audit issued by the GAO assumes additional reporting obligations. For a further discussion of those requirements, see chapter 4.

18.23 *Principal Auditor and Independence Issues.* The issuance of NCGA Statement 3 has resulted in increasing numbers of situations in which more than one auditor is involved in auditing the components of a reporting entity. A discussion of principal auditor and independence responsibilities in such situations appears in chapter 5.

18.24 *Reporting Other Financial Information Accompanying Basic Financial Statements.* A financial report of a governmental unit may include a wide variety of financial information in addition to the basic financial statements. The types of information typically included are supplemental financial statements, schedules, and statistical data. The manner in which the auditor reports on the additional information depends on the scope of the auditor's examination, the nature of the additional information, and whether the information is included in a client-prepared document or included in an auditor-submitted document.

18.25 If the additional information consists of combining or individual fund financial statements and related schedules, the auditor should report on such financial statements and schedules as discussed below. The auditor's examination ordinarily either includes procedures related to individual fund and account group data or constitutes an examination of those financial statements. In an auditor-submitted document, the auditor should also report on any other data included in the financial report as discussed in SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*. If the auditor's report is included in a client-prepared financial report, the auditor should follow the guidance in SAS No. 8, *Other Information in Documents Containing Audited Financial Statements*, with respect to statistical or other data that the auditor has not examined. Association of the auditor's report with financial statements included in bond official statements is discussed in chapter 19.

18.26 The statistical section usually contains multi-year comparisons and other financial and nonfinancial information. The independent auditor normally considers the entire statistical section as unaudited and, accordingly, issues a disclaimer of opinion or assures that the statistical section is clearly identified as not covered by the auditor's report. In practice, the latter procedure is usually followed.

18.27 *Prior Year Totals*. The financial statements recommended in GASB Cod. sec. 2200.601 include a column for prior year totals. Footnote 5 to SAS No. 15 discusses that situation and states that the auditor need not report on such information.

Auditors' Opinions

18.28 Many of the forms of reports that may be issued by the independent auditor are described in the following discussion.

18.29 *General Purpose or Component Unit Financial Statements Only*. If the auditor is engaged to examine a GPFS or CUFS of a governmental unit that presents only combined financial statements, the auditor should express an opinion on financial position, results of operations, and, for its proprietary fund types, the changes in financial position of the reporting entity or component unit (see Appendix A, example 1).

18.30 *General Purpose or Component Unit Financial Statements Presented With Combining, Individual Fund, and Account Group*

Financial Statements and Supporting Schedules. If the auditor is engaged to examine a GPFS or CUFS and also submits combining and individual fund and account group financial statements, SAS No. 29 applies and the auditor's report should state whether the combining and individual fund and account group financial statements are stated fairly in all material respects in relation to the GPFS or CUFS taken as a whole (see Appendix A, example 2). In addition, the auditor should be satisfied that the combining and individual fund financial statements are suitably titled. As discussed above, the scope of the auditor's examination ordinarily includes application of auditing procedures to individual fund and account group data, and the auditor is in a position to express an opinion on such accompanying information as provided by SAS No. 29.

18.31 If the auditor is engaged to examine the combining and individual fund and account group financial statements in addition to a GPFS or CUFS, the auditor's opinion addresses each presentation as a primary statement. Ordinarily, in such circumstances the auditor will need to expand the auditing procedures applied to the combining and individual fund and account group financial statements. If supporting schedules accompany those financial statements, the auditor's report should state whether the information in those schedules is presented fairly in conformity with GAAP in all material respects in relation to the financial statements of each of the individual funds and account groups taken as a whole or disclaim an opinion on such information (see Appendix A, example 3).

18.32 *Component Unit Financial Statements of Oversight Unit That Omit the Financial Statements of One or More Other Component Units*. GASB Cod. sec. 2100 establishes criteria for defining the reporting entity of a governmental unit. That section clarifies the organizations, functions, and activities of government (component units) that should be included in the GPFS of a governmental reporting entity. It recognizes that there may be circumstances in which an oversight unit may issue its separate component unit financial statements that exclude all other component units considered a part of the reporting entity, but establishes a requirement that the limitations of the financial statements be clearly disclosed. Such separate component unit financial statements for the oversight unit, in the absence of specific identification by the auditor, could be misinterpreted to be the complete financial statements of the reporting entity. Accordingly, when reporting on separate component unit financial statements for an oversight unit that exclude *all* other component units in the reporting entity, the auditor should properly describe the financial statements and include a middle paragraph in the report calling attention to the fact that the financial statements are not those of the reporting entity as that term is defined in GASB Cod. sec. 2100 (see Appendix A, example 4).

18.33 A reporting entity may include some, but not all, component units in the reporting entity financial statements. In that situation, the financial statements should be described as general purpose financial statements of the reporting entity and the auditor should consider the need to express a qualified or adverse opinion because of a departure from GAAP. A qualified or adverse auditor's report should include an explanatory paragraph that describes the omitted component unit and discloses the effects on the financial statements, if reasonably determinable (see Appendix A, example 5).

18.34 *General Purpose or Component Unit Financial Statements That Omit a Fund Type, Fund, or Account Group.* If financial statements for funds, fund types, or account groups that should be included in the GPFS or CUFS (such as the general fixed assets account group or an enterprise fund) are omitted, the auditor should consider the need to express a qualified or an adverse opinion on the financial statements because of a departure from GAAP. A qualified or adverse auditor's report should include an explanatory paragraph that describes the omitted fund type, fund, or account group and discloses the effects on the financial statements, if reasonably determinable (see Appendix A, examples 6 and 7).

18.35 *Individual Fund Financial Statements.* The auditor may be engaged to examine financial statements of only a specified fund or group of funds that are not intended to present fairly financial position, results of operations, or changes in financial position of either the reporting entity or component unit in conformity with GAAP. In such a case, the auditor's report should include a middle paragraph calling attention to the fact that the financial statements are not intended to present financial position and results of operations of the reporting entity or component unit (see Appendix A, examples 8 and 9).

18.36 *General Purpose or Component Unit Financial Statement* *for a Governmental Unit When a Question Arises About Ability to Meet Debts as They Come Due.* If a question has arisen about the ability of the governmental unit to meet its debts as they come due, the auditor should consider the need to qualify or disclaim an opinion on the financial statements (see Appendix A, example 10).

18.37 *General Purpose Financial Statements That Include Component Units That Have Not Been Audited.* Using the criteria established by GASB Cod. sec. 2100, many governmental units' financial reports have been expanded to include component units that were heretofore reported separately. In certain cases the financial statements of those units may be unaudited, which may result in the auditor's opinion on the general purpose financial statements being qualified or disclaimed, depending on the materiality of the unaudited component unit to the governmental unit's financial statements (see Appendix A, example 11).

18.38 *Part of the Examination Performed by Another Auditor.* When the auditor is serving as principal auditor and another auditor has examined a material portion of the financial statements, the principal auditor should consider the guidance in chapter 5 and whether to refer to the work of the other auditor (see Appendix A, examples 12 and 13).

Special Reports

18.39 If an independent auditor is engaged to examine financial statements prepared in conformity with a comprehensive basis of accounting other than GAAP, as defined in paragraph 4 of SAS No. 14, *Special Reports*, the independent auditor should follow the guidance in SAS No. 14 (see Appendix A, example 14).

18.40 If the auditor is engaged to examine financial statements presented in conformity with neither GAAP nor any other comprehensive basis of accounting, the auditor should use the standard form of report, modified because of the departures from GAAP.

Jointly Signed Reports

18.41 During recent years a number of governments have required that CPA firms proposing to perform examinations of their financial statements provide for minority or smaller firms, or both, to participate in the conduct of the examination. In some cases, those requirements have been met by principal auditors simply subcontracting a portion of the examination to the minority or smaller firms. In those circumstances the report on the examination is signed by only the principal auditor in the manner contemplated by SAS No. 1, section 543.

18.42 In other circumstances the independent auditors participating in the examination have each signed the report in their individual capacities. The profession's standards do not provide for sharing the responsibility for an examination of the financial statements of a single entity by two or more independent auditors. Each individual or firm signing an audit report should be considered to be separately expressing an opinion on the financial statements. Signing the report in an individual capacity is appropriate only if the individual or firm has complied with GAAS and is in a position that would justify being the only signatory of the report.

18.43 A joint endeavor by two firms to conduct an audit could take the form of a legal entity just as individuals band together to form a firm. In that situation, the report might be signed with the joint venture name. However, before undertaking such an approach, the auditors should consider the implications of ethics rules on the use of fictitious names and state licensing statutes.

18.44 Independent auditors have also been requested to participate jointly with government auditors in the performance of joint examinations. In such situations, it is important to evaluate the independence of the government auditor in addition to other factors. The Standards for Audit issued by the GAO would be helpful in that evaluation. The same responsibilities, previously described, relating to joint signatures apply in these circumstances.

Chapter 19

Association With Financial Statements Included in Official Statements

19.1 Debt securities are generally offered on either a negotiated or a competitive bid basis. Negotiated offerings are made by the issuer to one or more underwriters, who may then resell the securities to the public. Competitive bid sales are based on sealed bids submitted by underwriters. The issuer generally sells the securities to the underwriter or the underwriting group that submitted the best acceptable bid. An official statement is generally prepared by the issuer of debt securities, often without involvement of the auditor.

19.2 Following the financial crisis of New York City in 1975, governmental units, underwriters, bond counsel, fiscal advisers, rating agencies, professional groups, and others expressed concern with the apparent inadequacy of the financial statements and financial disclosures used in connection with the sale of municipal securities. As a result, the Government Finance Officers Association in 1976 published the booklet, *Disclosure Guidelines for Offerings of Securities by State and Local Governments*, which provides guidelines for the preparation of official statements and suggests the format and content of information contained in them. The guidelines suggest that the general purpose financial statements with an auditor's report be included in the official statement. Since the initial publication of the guidelines, financial and other information concerning the issuing governmental unit included in official statements have substantially increased and improved. In 1979, the GFOA published an updated and revised version of the guidelines entitled *Disclosure Guidelines for State and Local Governments*.

Official Statement Responsibilities

19.3 Though governmental units are exempt from the reporting and registration requirements under the Securities Act of 1933 and the Securities Exchange Act of 1934, the federal antifraud provisions of those acts that relate to the adequacy of disclosures apply to governmental unit security offerings. The best known of those provisions is section 10b-5 of the Securities Exchange Act of 1934, which imposes civil liability for unlawful acts, for example, misrepresentations or omissions of material facts by any person in the offering or sale of securities, including securities issued by governmental units.

19.4 An auditor has no obligation to participate in or undertake to perform any procedures with respect to an official statement. If engaged in or otherwise involved in a securities offering the auditor should refer to SAS No. 8, *Other Information in Documents Containing Audited Financial Statements*, for guidance on responsibilities concerning information in the official statement other than the financial statements covered by his opinion. SAS No. 8 provides that —

> The auditor has no obligation to perform any procedures to corroborate other information contained in a document. However, he should read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements. [section 550.04]

19.5 SAS No. 8 further suggests the action an auditor should take if it is concluded from that reading that there is a material inconsistency between the financial statements and the other information presented or that there is a material misstatement of fact in the other information.

19.6 Moreover, if involved in an offering statement the auditor should consider the additional guidance provided in SAS No. 37, *Filings Under Federal Securities Statutes*. SAS No. 37 provides that "an auditor should extend his procedures with respect to subsequent events from the date of his audit report up to the effective date [of the sale of the securities]." Those subsequent events procedures are discussed in SAS No. 1, section 560.

19.7 The aforementioned guidance is applicable when the auditor is involved in an official statement. The auditor is deemed to be involved in an offering if he or she —

- Manually signs the auditor's report included in the offering document.
- Provides written consent to the use of the auditor's report in the official statement.
- Reviews a draft of the official statement at the client's request.
- Assists in the preparation of the financial information included in an official statement.
- Issues a comfort letter on information included in an official statement.

Comfort Letters

19.8 Underwriting agreements between the governmental issuer and the underwriters may require the auditor to prepare a "comfort letter" addressed to the underwriters. If so, the auditor should follow the guidance and reporting examples provided in SAS No. 49, *Letters for Underwriters*.

Consents and Experts

19.9 The financial adviser for the governmental unit or the legal counsel for either the governmental unit or the underwriter may request a consent and citation of expertise from the auditor. Those items apply only to filings under the Securities Acts. The auditor may nevertheless agree to furnish the consent and expert citations if engaged to be associated as discussed above. In such instances, the auditor should refer to SAS No. 37 for guidance.

Part VI
Other Matters

Chapter 20

Unresolved Accounting Issues

20.1 Current financial accounting and reporting for state and local governments involves a number of controversial and contentious issues. A Governmental Accounting Standards Board (GASB), operating under the broad direction of the Financial Accounting Foundation, was established in 1984. The GASB is composed of a full-time chairman and four part-time members, supported by administrative, technical, and research staff. The GASB has recognized numerous financial accounting and reporting issues that need resolution and has placed some of them on its active agenda. This chapter describes some of those issues.

Accounting and Financial Reporting for Public Employee Retirement Systems

20.2 Both the NCGA and the FASB have issued accounting and financial reporting standards for state and local government pension plans. The FASB promulgated Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, in March 1980 and the NCGA issued Interpretation No. 4, *Accounting and Financial Reporting for Public Employee Retirement Systems and Pension Trust Funds*, in December 1981. Interpretation No. 4 was superseded by NCGA Statement 6, *Pension Accounting and Financial Reporting: Public Employee Retirement Systems and State and Local Government Employers*. Both organizations have deferred implementation of their pronouncements, however, because of conflict in two primary areas: basis for recording investments and benefit-liability determinations. FASB Statement No. 75 and NCGA Interpretation No. 8 were issued to achieve that mutual deferral.

20.3 FASB Statement No. 35 requires investments, including debt and equity securities, to be presented at market value. NCGA Statement 6 requires equity securities be presented generally at cost and debt securities be presented at amortized cost. Though the NCGA prescribes the FASB Statement No. 35 computation method of determining the actuarial present value of accumulated plan benefits, NCGA Statement 6 mandates consideration of salary increases in computations and disclosures related to vested and nonvested benefits.

20.4 The GASB is studying those conflicts and the general area of financial accounting and reporting by pension plans and their sponsors.

The Current Reporting Fund Structure

20.5 A number of proposals have been made recently to reduce or eliminate the use of existing fund types and account groups in financial statements prepared in conformity with GAAP. Suggestions have ranged from the elimination of only a single fund type, such as special assessment funds, to reporting only a single total amount combining all of the fund types and account groups. Several units of government have published financial statements that combine or consolidate fund structures in a variety of ways. Independent auditor reports on those financial statements have varied due to the varied forms of financial presentations and the experimental nature of the presentations. Reporting based on funds and account groups is a topic of continuing professional interest and controversy.

The Current Reporting Measurement Focus

20.6 The current financial statements of governmental fund types focus on the sources and uses of financial resources, using the modified accrual basis of accounting. Reporting on proprietary fund types, however, uses the accrual basis in which revenues and expenses are determined in addition to reporting sources and uses of financial resources. Two fundamental issues generate controversy in that area.

20.7 The first relates to whether governmental type funds should continue to follow their current measurement focus. The second relates to the accounting basis on which revenues and expenditures should be recognized.

Other Issues

20.8 A variety of other controversial issues continue to require attention, including the appropriate financial accounting and reporting practices for—

- Plant assets and related depreciation in governmental accounting.
- Budgetary accounting comparisons and display in basic financial statements.
- Information about the replacement cost of assets.
- The definition of current liabilities of governmental units.
- Accounting for special assessment funds.
- The absence of insurance.
- Deferred maintenance costs.
- Compensated absences.
- Unusual debt terms such as *deep discount bonds* or *zero coupon bonds*.

20.9 All of those issues are controversial and difficult. Their resolution will require more deliberation and debate and are among the topics to be considered by the GASB. Readers should refer to GASB publications for further information about these and other projects that may be controversial or under consideration.

Part VII
Audits of Federal Financial Assistance

Chapter 21

Single Audit Planning and Other Considerations

21.1 Chapter 17 presents an overview of the single audit and describes the basic provisions of the Single Audit Act of 1984 and OMB Circular A-128. This chapter introduces and discusses the auditing and reporting requirements the auditor should consider in planning those aspects of a single audit related to the issuance of reports relating specifically to the organization's federal financial assistance programs. Chapters 22 and 23 address performance and reporting considerations.

21.2 The Single Audit Act includes not only audit requirements related to federal financial assistance programs, but also includes auditing and reporting requirements related to the general purpose or basic financial statement examination of the entity. Earlier chapters of this guide discuss the auditing and reporting requirements related to the general purpose or basic financial statements.

21.3 The auditor should be familiar with the requirements for audits of federal financial assistance programs. In planning, conducting, and reporting in connection with a single audit, independent auditors should become familiar with the following pertinent documents, many of which are discussed further in this guide.

- The Single Audit Act of 1984 (Appendix D)
- OMB Circular A-128, *Audits of State and Local Governments* (Appendix E)
- OMB Circular A-87, *Cost Principles Applicable to Grants and Contracts* (Appendix C contains a synopsis)
- OMB Circular A-102, *Uniform Requirements for Assistance to State and Local Governments* (Appendix C contains a synopsis)

- *Standards for Audit of Governmental Organizations, Programs, Activities, and Functions*
- *OMB Compliance Supplement for Single Audits of State and Local Governments*
- *Federal Cognizant Agency Audit Organization Guidelines*
- *OMB Catalog of Federal Domestic Assistance*

21.4 In planning examinations, auditors should determine the nature, extent, and timing of work to be performed and should prepare written audit programs. The Single Audit Act, Circular A-128, and the Standards for Audit issued by the GAO establish some special audit requirements and considerations significant to federal program managers and other users of the federal financial assistance program financial statements and reports. Those requirements and other important considerations include—

- Specific reporting requirements.
- Internal controls (accounting and administrative) used in administering federal financial assistance programs.
- Legal and regulatory compliance requirements.
- Findings and questioned costs.
- Working papers.
- Disclosure of irregularities and illegal acts.
- Identification of federal financial assistance programs.
- Subgrantees (or subrecipients) of federal financial assistance programs.
- Determination of the audit period.
- Initial-year audit considerations.
- Relationships with the cognizant agency.
- Responsibilities of the cognizant agency.
- Joint audit considerations.

Specific Reporting Requirements

21.5 The Single Audit Act, Circular A-128, and the Standards for Audit issued by the GAO extend the auditor's reporting responsibilities beyond the expression of an opinion on the general purpose or basic financial statements of the governmental unit to include the issuance of additional internal control and compliance reports. To comply with the requirements of Circular A-128, with respect to the federal financial assistance programs, the auditor should report on—

- The supplemental schedule of federal financial assistance.
- Internal control (accounting and administrative) systems used in administering federal financial assistance programs.
- Compliance with laws and regulations.

Internal Controls (Accounting and Administrative) Used in Administering Federal Financial Assistance Programs

21.6 The Single Audit Act and Circular A-128 define internal controls for federal financial assistance program purposes as the plan of organization and methods and procedures adopted by management to ensure that—

(1) Resource use is consistent with laws, regulations, and policies;
(2) Resources are safeguarded against waste, loss, and misuse; and
(3) Reliable data are obtained, maintained, and fairly disclosed in reports.

21.7 By that definition, the auditor's study and evaluation of internal control (accounting and administrative) systems used in administering federal financial assistance programs in accordance with the Single Audit Act and OMB Circular A-128 encompass applicable internal accounting controls as well as those internal administrative controls related to federal financial assistance programs.

21.8 To distinguish this more comprehensive approach, those internal controls will be referred to throughout the remainder of this guide as *internal controls (accounting and administrative) used in administering federal financial assistance programs* to distinguish them from the larger set of internal controls of which they are a part. Examples of the nature of administrative controls that auditors would include in their review of such controls are presented in footnote 1 to example 20 of Appendix A.

21.9 The Single Audit Act and Circular A-128 require the auditor to determine and report on whether the organization has internal control (accounting and administrative) systems to provide reasonable assurance that it is managing federal financial assistance programs in compliance with applicable laws and regulations. OMB Circular A-128 further provides that a study and evaluation of those controls must be made regardless of whether the auditor intends to place reliance on such systems. As part of this study and evaluation, the auditor should—

- Test whether those internal control (accounting and administrative) systems are functioning in accordance with prescribed procedures.
- Examine the recipient's system for monitoring subrecipients [control systems] and obtaining and acting on subrecipients' audit reports.

21.10 A literal interpretation of the Single Audit Act would require the auditor to study and evaluate each system used by the recipient regardless of the dollar amount of the program expenditures. However, the following approach for conducting such reviews was developed in consultation with representatives of OMB, GAO, and the Inspectors General.

21.11 The extent of the auditor's study and evaluation of internal control (accounting and administrative) systems used in administering major federal financial assistance programs should be the type of study and evaluation the auditor would perform in accordance with SAS No. 1, sec. 320.56-.72 (as amended by SAS No. 48), if intending to rely on all of the existing control cycles to restrict the extent of substantive testing. In performing such study and evaluation, the auditor should include all significant control cycles that relate to major federal financial assistance program activities.

21.12 The auditor may find that the total amount of major federal financial assistance program expenditures is less than 50 percent of the recipient organization's total federal financial assistance expenditures. In such circumstances, the auditor should extend the study and evaluation to include controls over the largest nonmajor programs so that controls over at least 50 percent of federal financial assistance program expenditures are studied and evaluated.

21.13 The auditor's study and evaluation of internal control (accounting and administrative) systems relating to all other nonmajor federal financial assistance programs at a minimum should be comparable to the "preliminary review" outlined in AU sec. 320.53, which states—

> The preliminary phase of such a review should be designed to provide the auditor with an understanding of the control environment and the flow of transactions through the accounting system. An understanding

of the control environment should provide the auditor with a general knowledge of such matters as the organizational structure, the methods used by the entity to communicate responsibility and authority, and the methods used by management to supervise the system, including the existence of an internal audit function, if any. An understanding of the flow of transactions should provide the auditor with a general knowledge of the various classes of transactions and the methods by which each significant class of transactions is authorized, executed, initially recorded, and subsequently processed, including the methods of data processing. The auditor's understanding ordinarily is obtained by a combination of previous experience with the entity, inquiry, observation, and reference to prior-year working papers, client-prepared descriptions of the system, or other appropriate documentation.

21.14 If the recipient organization has no major federal financial assistance programs (as defined in the Single Audit Act and OMB Circular A-128), the scope of the study and evaluation of internal controls (accounting and administrative) used in administering federal financial assistance programs should be comparable to the scope applicable to major federal financial assistance programs as described in paragraph 21.11 for the largest programs that in the aggregate are equal to or greater than 50 percent of the total federal financial assistance program expenditures. The auditor's study and evaluation of internal control (accounting and administrative) systems relating to the remainder of nonmajor federal financial assistance programs need not exceed the preliminary review.

21.15 Though the Single Audit Act requires a report on internal controls, it does not require the auditor to express an opinion on the internal control systems used in administering federal financial assistance programs.

21.16 If there is only one internal control (accounting and administrative) system operated to ensure compliance with federal financial assistance requirements, the auditor's study and evaluation of that system should be comparable in scope to that described in paragraph 21.11. However, federal financial assistance programs are often administered by several organizational components within a recipient government. Each component usually maintains a separate internal control (accounting and administrative) system for ensuring compliance with the programs it administers. In those situations, the auditor should study and evaluate each separate system in accordance with the criteria previously discussed.

Legal and Regulatory Compliance Requirements

21.17 The review of compliance performed in connection with the examination of the general purpose or basic financial statements of the entity is described in Chapter 4.

21.18 The auditor may ascertain the principal compliance requirements of the largest federal financial assistance programs by referring to the *Compliance Supplement for Single Audits of State and Local Governments* (*Compliance Supplement*), issued by OMB and available from the Government Printing Office. For other programs, the auditor may ascertain compliance requirements by researching the statutes, regulations, and agreements governing individual programs. For purposes of assessing compliance with laws and regulations in the performance of a single audit, a material event of noncompliance is generally one that could result in the audited organization being required to refund funds to the agency providing financial assistance or make other restitutions for improper disbursements in an amount that is material in relation to the affected federal assistance program. In assessing compliance, the auditors should use their professional judgment in considering which laws and regulations may have a material effect on the allowability of program expenditures for each major federal financial assistance program.

21.19 Circular A-128 requires the auditor's report on compliance with laws and regulations to contain—

- A statement of positive assurance with respect to those items tested for compliance, including compliance with laws and regulations pertaining to financial reports and claims for advances and reimbursements.
- Negative assurance on those items not tested.
- A summary of all instances (findings) of noncompliance.
- An identification of total amounts of questioned costs, if any, for each federal financial assistance award related to acts of noncompliance.

The reporting for major federal financial assistance programs was reviewed with representatives of the GAO, OMB, and the Inspectors General. It was concluded that to comply with the positive and negative assurance reporting requirements related to such programs the auditor should express an opinion on compliance with applicable laws and regulations.

21.20 To comply with those reporting requirements, the auditor may issue either separate reports or one report that combines the following elements:

- With respect to compliance with laws and regulations noncompliance with which the auditor believes could materially affect the general purpose or basic financial statements (an entitywide perspective), explicit statements of positive assurance concerning compliance for the items tested and negative assurance concerning compliance for the items not tested.
- With respect to compliance with laws and regulations noncompliance with which the auditor believes could materially affect the allowability of program expenditures for each major federal financial assistance program (a federal program perspective), *an opinion* on whether the audited organization is in compliance, in all material respects, with laws and regulations.
- With respect to compliance with laws and regulations that affect nonmajor federal financial assistance programs, positive assurance concerning compliance for the items tested and negative assurance concerning compliance for the items not tested.

21.21 If the auditor's testing discloses instances of noncompliance, the statement related to negative assurances should be worded so it does not apply to those laws and regulations for which instances of noncompliance were identified.

21.22 With respect to major federal financial assistance programs, the auditor should obtain reasonable assurance that the organization has complied in all material respects with applicable laws and regulations noncompliance with which the auditor believes could materially affect the allowability of program expenditures for *each* of its major federal financial assistance programs. In accordance with Circular A-128, at a minimum, a representative number (a sample that is expected to be representative of the population) of transactions from each major federal financial assistance program should be selected and tested. The extent of the auditor's testing should be sufficient to provide a basis for expressing an opinion on whether the audited organization has complied, in all material respects, with laws and regulations the auditor believes could materially affect the allowability of program expenditures for each major federal financial assistance program of the organization. The auditor should also be aware and consider in his tests that there may be violations of laws and regulations, such as violations of civil rights and failure to hold required public hearings (see paragraph 22.6) that could materially affect the overall allowability of program expenditures but do not directly involve individual expenditures.

21.23 Circular A-128 also requires that transactions related to nonmajor federal financial assistance programs selected in connection with the examination of the general purpose or basic financial statements and the studies and evaluations of internal controls be tested for compliance with federal laws and regulations.

Findings and Questioned Costs

21.24 Standards for Audit issued by the GAO identifies as special terms audit *findings* and *questioned costs.* It describes a finding as the "result of information development; a logical pulling together of information...about an organization, program, activity, function, condition, or other matter which was analyzed or evaluated and considered to be of interest, concern, or use to the entity." It also states that factual data supporting all findings should be presented accurately and fairly in the auditor's report and that those findings should be adequately supported by sufficient evidence in the working papers

21.25 Circular A-128 requires that the auditor's report on compliance contain a summary of *all* findings of noncompliance and an identification of total amounts questioned, if any, for each federal financial assistance award, as a result of noncompliance. For example, the auditor may conclude that a finding related to the late filing of quarterly financial status reports would not have a material effect on the entity's financial statements or the supplementary schedule of federal financial assistance programs. However, because the auditor should report *all* noncompliance findings, the instance of noncompliance described would be reportable.

21.26 Though the term *questioned costs* is not defined by the GAO, such costs are often considered those that, in the opinion of the auditor, may not comply with or may not be consistent with the requirements set forth in contracts, statutes, or regulations governing the allocability, allowability, or reasonableness of costs charged to awards and programs, and thus may not be reimbursable. Chapter 22 provides additional guidance on the reporting criteria to be used in reporting questioned costs.

Working Papers

21.27 Circular A-128, implementing the requirements of the Single Audit Act, requires auditors to retain workpapers and reports for a minimum of three years from the date of the audit report, unless the auditor is notified in writing by the cognizant agency to extend the retention period. Audit workpapers are required to be made available on request to the cognizant agency or its designee, or the GAO. The auditor should also be familiar with the working paper requirements contained in the Standards for Audit issued by the GAO.

Disclosure of Irregularities and Illegal Acts

21.28 SAS No. 16, *The Independent Auditor's Responsibility for the Detection of Errors or Irregularities*, and SAS No. 17, *Illegal Acts by Clients*, discuss the auditor's responsibilities with respect to irregularities and illegal acts. Auditors who are government employees should refer to Standards for Audit issued by the GAO, pages 28 and 29, which describes their additional responsibilities for reporting fraud, abuse, or illegal acts, or indications of such acts.

21.29 If the auditor becomes aware of illegal acts or other irregularities, Circular A-128 requires that prompt notice be given to recipient management officials above the level of involvement. The recipient, in turn, should promptly notify the cognizant agency of the illegal acts or irregularities and of proposed and actual actions, if any. Illegal acts and irregularities include matters such as conflicts of interest, falsification of records or reports, and misappropriations of funds or other assets.

21.30 Additionally, the Standards for Audit issued by the GAO (page 26) states—

> The auditors shall extend audit steps and procedures if the examination indicates that fraud, abuse, or illegal acts may have occurred. The extended audit steps should be directed to obtaining sufficient evidence to determine whether in fact they have occurred and, if so, the possible effect on the entity's financial statements.

The auditor should be aware that the Standards for Audit issued by the GAO also requires that all fraud, abuse, or illegal acts, whether material or not, that come to the attention of the auditor should be covered in a separate written report. Usually, management is aware of this reporting requirement. The auditors should consider documenting in their working papers discussions with the cognizant agency concerning the timely notification of irregularities or illegal acts.

Identification of Federal Financial Assistance Programs

21.31 Though the OMB is developing a system to identify recipients of federal assistance, referred to as the Federal Assistance Award Data System (FAADS), presently there is no single centralized source for identifying all federal financial assistance provided to an individual recipient. Therefore, audit procedures should include a review of contract files and receipts and disbursements to obtain reasonable assurances that the recipient organization has appropriately identified all federal financial assistance received and included within the scope of the single audit.

21.32 The Single Audit Act provides that a state or local government shall be considered to receive federal financial assistance whether such assistance is received directly from a federal agency or indirectly as a pass-through from another state or local government.

Subgrantees (or Subrecipients) of Federal Financial Assistance Programs

21.33 Many primary recipient governmental units make subcontract or subgrant awards and disburse their own funds as well as federal funds to subrecipients. In many instances, the amount of these payments is material to the primary recipient's financial statements.

21.34 Under the requirements of the Single Audit Act, if a primary recipient receives federal financial assistance and provides $25,000 or more of such assistance to a subrecipient in a fiscal year, the primary recipient is responsible for determining that the expenditures of federal monies passed through to subrecipients are utilized in accordance with applicable laws and regulations. Further, OMB Circular A-128 provides that in such instances, the primary recipient should—

- Determine whether state or local subrecipients have met the audit requirements of Circular A-128 and where applicable, subrecipients covered by Circular A-110, *Uniform Requirements for Grants to Universities, Hospitals, and Other Nonprofit Organizations*, have met those unique requirements;

- Determine whether the subrecipient spent federal assistance funds provided in accordance with applicable laws and regulations;
- Ensure that appropriate corrective action is taken within six months after receipt of the [subrecipient] audit report on [reported] instances of noncompliance with federal laws and regulations;
- Consider whether subrecipient audits necessitate adjustment of the recipient's own records; and
- Require each subrecipient to permit independent auditors to have access to their records and financial statements as necessary to comply with Circular A-128.

Those responsibilities may be discharged by relying on independent audits performed of the subrecipients, relying on appropriate procedures performed by the primary recipient's internal audit or program management personnel, expanding the scope of the independent financial and compliance audit of the primary recipient to encompass testing of subrecipients' charges, or a combination of those procedures.

21.35 The primary recipient is responsible for reviewing audit and other reports submitted by subrecipients and identifying questioned costs and other findings pertaining to the federal financial assistance passed through to the subrecipients, and properly accounting for and pursuing resolution of questioned costs and ensuring that prompt and appropriate corrective action is taken on instances of material noncompliance with laws and regulations.

21.36 Because noncompliance by a subrecipient could result in questioned costs to the primary recipient, the auditor should study and evaluate the controls established to monitor subrecipients' compliance. This should include evaluating procedures established by the primary recipient to identify instances of subrecipient noncompliance with laws and regulations. The extent of the study and evaluation should be based on the major or nonmajor federal financial assistance program considerations discussed earlier in this guide.

21.37 The specific exceptions reported in a subrecipient's audit report are not required to be included in the primary recipient's audit report. However, the auditor should consider the effects of reported exceptions, or events, or indications of material weaknesses in the primary recipient's monitoring system that could have a material effect on each major federal financial assistance program of the primary recipient.

Determination of the Audit Period

21.38 A single audit should cover the reporting entity's financial transactions for its fiscal year, not the period of the program being funded. Thus, the examination might include only a part of the transactions of an assistance program, because a portion of a program's transactions might not fall within the period covered by the audit.

Initial-Year Audit Considerations

21.39 An auditor accepting, or contemplating accepting, an engagement in which the federal financial assistance programs of the preceding period were audited by another auditor should be guided by SAS No. 7, *Communications Between Predecessor and Successor Auditors*. If the federal financial assistance programs have not been previously audited, the auditor should discuss with the recipient and the cognizant agency the need to perform any additional audit work for the prior unaudited periods. If additional special work is not required, testing for the prior unaudited period would be limited to balances as of the end of that unaudited period.

Relationships With the Cognizant Agency

21.40 Independent auditors should, where warranted and practicable, communicate with the cognizant agency before, during, and after the audit to avoid or minimize disagreements or other problems. The auditor may desire to discuss with the cognizant agency, through the recipient organization, such matters as the audit plan, the scope of testing of programs for specific compliance requirements, the intended use of the OMB's *Compliance Supplement*, any sampling plan, and other audit matters, as deemed appropriate.

21.41 If the cognizant agency disagrees with significant elements of the audit plan, those matters should be resolved between the recipient, the cognizant agency, and the auditor before fieldwork commences.

Responsibilities of the Cognizant Agency

21.42 The OMB has designated cognizant agencies for state agencies and large local governmental units. Smaller governments not assigned a cognizant agency are under the general oversight of the federal agency that provides them with the most funds, whether directly or indirectly.

21.43 Circular A-128 states that a cognizant agency shall have the following responsibilities:

a. Ensure that audits are made and reports are received in a timely manner and in accordance with the requirements of the Circular.

b. Provide technical advice and liaison to state and local governments and independent auditors.

c. Obtain or make quality control reviews of selected audits made by nonfederal audit organizations, and provide the results, when appropriate, to other interested organizations.

d. Promptly inform other affected federal agencies and appropriate federal and local law enforcement officials of any reported illegal acts or irregularities.

e. Advise the recipient of audits that have been found not to have met the requirements set forth in the Circular. In such instances, the recipient will be expected to work with the auditor to take corrective action. If corrective action is not taken, the cognizant agency shall notify the recipient and federal awarding agencies of the facts and make recommendations for follow-up action. Major inadequacies or repetitive substandard performance of independent auditors shall be referred to appropriate professional bodies for disciplinary action.

f. Coordinate, to the extent practicable, audits made by or for federal agencies that are in addition to the audits made pursuant to the Circular, so that the additional audits build upon such audits.

g. Oversee the resolution of audit findings that affect the programs of more than one agency.

21.44 Additional information on cognizant agency responsibilities is contained in the *Federal Cognizant Agency Audit Organization Guidelines*. It provides guidance for promoting quality audits, processing audit reports, and providing notification of irregularities. Auditors should be familiar with its contents before conducting a single audit.

21.45 Though each federal agency has agreed to exercise its cognizant responsibilities in accordance with policies set forth in the *Federal Cognizant Agency Audit Organization Guidelines*, those guidelines are limited to broad policy statements and leave the design and execution of specific procedures to the individual cognizant agencies. The auditor should not presume that all conditions agreed to by a cognizant agency for one engagement will be the same for other engagements.

Joint Audit Considerations

21.46 In conducting a single audit, there may be instances when it will be necessary to refer to the work of other auditors in a principal auditor's report. There may be instances where the audit may be performed by more than one auditor, such as in prime-subcontractor or joint-examination arrangements.

21.47 The Single Audit Act requires OMB to prescribe policies, procedures, and guidelines..."as may be necessary to ensure that small business concerns and business concerns owned and controlled by socially and economically disadvantaged individuals will have the opportunity to participate in the performance of contracts awarded to fulfill the audit requirements of this chapter" (sec. 7505(c)). Circular A-128 provides such guidelines. Reference should be made to chapter 18 for a discussion of auditors' responsibilities when issuing jointly signed reports.

Chapter 22

Performing the Single Audit

Auditing Federal Financial Assistance Programs

22.1 Federal financial assistance is defined broadly in the Single Audit Act to include assistance provided by a federal agency in the form of grants, contracts, loans, loan guarantees, property, cooperative agreements, interest subsidies, insurance, or direct appropriations. The term does not include direct federal cash assistance to individuals.

22.2 Though there is no requirement for the auditor to test all federal financial assistance programs, the Single Audit Act does contain specific audit requirements for major federal financial assistance programs, as defined.

Defining Major Federal Financial Assistance Programs

22.3 Under the Single Audit Act, the auditor shall determine and report on whether the recipient has complied with laws and regulations that may have a material effect on each major federal financial assistance program. A program may include several grants and contracts and other forms of federal financial assistance and those terms should not be confused. For example, low-income housing assistance is a program under which several individual grants could be issued to a recipient. The Single Audit Act defines a major federal financial assistance program as any program (usually listed in the *Catalog of Federal Domestic Assistance*) for which total expenditures (not receipts) of federal financial assistance during the applicable year exceed—

- $20 million when expenditures for all programs exceed $7 billion.
- $19 million when expenditures for all programs exceed $6 billion, but are less than or equal to $7 billion.

- $16 million when expenditures for all programs exceed $5 billion, but are less than or equal to $6 billion.
- $13 million when expenditures for all programs exceed $4 billion, but are less than or equal to $5 billion.
- $10 million when expenditures for all programs exceed $3 billion, but are less than or equal to $4 billion.
- $7 million when expenditures for all programs exceed $2 billion, but are less than or equal to $3 billion.
- $4 million when expenditures for all programs exceed $1 billion, but are less than or equal to $2 billion.
- $3 million when expenditures for all programs exceed $100 million, but are less than or equal to $1 billion.
- The larger of $300 thousand or 3 percent of such total expenditures for all programs when expenditures for all programs exceed $100 thousand, but are less than or equal to $100 million.

Basic Single Audit Requirements

22.4 OMB Circular A-128 states—

(1) In order to determine which major programs are to be tested for compliance, state and local governments shall identify in their accounts all federal funds received and expended and the programs under which they were received. This shall include funds received directly from federal agencies and those passed through from other state and local governments or other entities.

(2) The review [audit] must include the selection and testing of a representative number of charges from each major federal financial assistance program. The selection and testing of transactions shall be based on the auditor's professional judgment considering such factors as the amount of expenditures for the program and the individual awards; the newness of the program or changes in its conditions; prior experience with the program, particularly as revealed in audits and other evaluations (e.g., inspections, program reviews); the extent to which the program is carried out through subrecipients; the extent to which the program contracts for goods or services; the level to which the program is already subject to program reviews or other forms of independent oversight; the adequacy of the controls for ensuring compliance; the expectation of adherence or lack of adherence to the applicable laws and regulations; and the potential impact of adverse findings.

(a) In making the test of transactions, the auditor shall determine whether:

—The amounts reported as expenditures were for allowable services, and

—The records show that those who received services or benefits were eligible to receive them.

(b) In addition to transaction testing, the auditor shall determine whether:

—Matching requirements, levels of effort and earmarking limitations were met,

—Federal financial reports and claims for advances and reimbursements contain information that is supported by the books and records from which the [general purpose or] basic financial statements have been prepared, and

—Amounts claimed or used for matching were determined in accordance with OMB Circular A-87, "Cost principles for State and Local Governments," and Circular A-102, "Uniform Requirements for Grants to State and Local Governments."

In determining the nature, timing, and extent of testing, the auditor should consider audit risk and materiality related to each major federal financial assistance program.

Identifying Compliance Requirements—The Compliance Supplement

22.5 To assist the independent auditor in determining which federal compliance requirements should be used for testing transactions and records, the OMB published the *Compliance Supplement*, specifying the general and the specific program compliance requirements for significant federal financial assistance programs. The specific compliance requirements and suggested audit procedures have been provided for certain programs. Auditors may refer to the statute or Code of Federal Regulations identified in the *Compliance Supplement* to obtain a complete understanding of the compliance requirements. These specific requirements may change periodically and auditors should be alert to this possibility through contact with the federal agencies, the audited organizations, subscription services, or by other means. The cognizant agency should provide assistance in this regard. There are several publication services that provide current developments and changes in single audit laws and regulations that may be useful to the auditor. In addition to reviewing, to the extent deemed necessary, applicable statutes and the Code of Federal Regulations, the auditor may also review award documents and procedure manuals to gain familiarity with the federal compliance requirements. The legislative reports that accompany the Single Audit Act state that though the auditor may find the *Compliance Supplement* useful guidance, its use is not mandatory. However, federal inspectors general recommend its use.

22.6 *General Requirements for Compliance Testing.* The *Compliance Supplement* identifies certain general compliance requirements. The requirements include—

- *Political activity (Hatch Act and Intergovernmental Personnel Act of 1970, as amended)*—These acts specify that federal funds cannot be used for political activity of any kind. This general prohibition applies to all federal financial assistance programs.
- *Construction contracts (Davis-Bacon Act)*—All construction programs are required to follow the provisions of the Davis-Bacon Act, which in general requires that laborers and mechanics employed by contractors of federally funded projects be paid at wages not less than those established by the secretary of labor as the prevailing regional wage rate.
- *Civil rights*—Federal aid programs provide that no person shall be excluded from participation in, or be subjected to discrimination in, any program funded, in whole or in part, by federal funds because of race, color, national origin, sex, age, or physical impairment.
- *Cash management*—Many recipients receive funds through a letter of credit arrangement with the grantor agency. Cash should be withdrawn only in amounts necessary to meet immediate needs or to cover program disbursements already made.
- *Relocation assistance and real property acquisition*—Federal financial assistance programs that require the acquisition of property by a public agency and subsequent displacement of households and businesses provide that such recipients carry out certain actions.
- *Federal financial reports (OMB Circular A-102, Attachment H)*—Attachment H requires that recipients of federal financial assistance file four financial reports for each federal financial assistance program. A later discussion covers the review of federal financial reports.

22.7 Suggested audit procedures for these general compliance requirements are included in the OMB *Compliance Supplement.* The auditor should use professional judgment in deciding whether to perform additional or alternative tests and procedures to determine the adherence, or lack of adherence, to a general requirement.

22.8 *Specific Program Requirements for Compliance Testing.* The OMB *Compliance Supplement* provides a list of specific program requirements (specific compliance requirements) and suggested audit procedures for many assistance programs. The specific requirements are organized into the following five categories:

- Types of service allowed or unallowed
- Eligibility
- Matching, level of effort, and earmarking
- Reporting
- Special provisions

22.9 Once again, though each requirement in the *Compliance Supplement* is accompanied by suggested audit procedures that can be used to test for compliance with laws and regulations, those are not the only audit procedures that an auditor may use. The auditor should use professional judgment in determining adherence to laws and regulations.

22.10 Auditors should be alert for possible violations of any of the compliance requirements throughout the engagement. If the auditors discover a violation, regardless of how discovered, they should disclose the violation in their report on compliance.

Other Testing Considerations

22.11 The following are important considerations when performing a financial and compliance audit of federal financial assistance programs.

22.12 *Are the charges necessary and reasonable for the proper administration of the program?* The purpose, authorization, and timing of transactions should be examined in relation to whether such transactions are of a type generally recognized as ordinary, prudent, relevant, and necessary within established practices. For example, necessary costs would include expenditures for goods or services for the program being charged, in quantities that would be considered normal for the nature of the activities conducted, and at a price that is competitive. Federal agencies have defined *reasonable costs* as those costs, by nature and amount, that would not exceed the costs incurred by the ordinarily prudent person in the conduct of a competitive business. The provisions of the OMB Circular A-87, *Cost Principles for State and Local Governments*, which defines numerous allowable costs, unallowable costs, and costs requiring approval of federal grantors, are particularly useful in making these determinations.

22.13 *Do the charges conform to any limitations or exclusions in the federal assistance agreement?* One federal program may limit the amount of indirect costs that may be charged to it; another program may permit charging only direct costs to the program, including some that might otherwise be included as indirect costs. Further, the recipient government may have agreed that certain costs should be considered as unallowable as a charge to the program. Costs that are contrary to the conditions of a specific program or contrary to federal government policy or law must be reported.

22.14 *Were the charges given consistent accounting treatment and applied uniformly to both federally assisted and other activities of the recipient?* Consistency relates to applying the same accounting treatment in a similar manner to similar transactions within a reporting period and from one reporting period to another. Additionally, the accounting methods and practices should be the same and uniformly applied to both federal and nonfederal activities within and between reporting periods.

22.15 *Were the charges net of applicable credits?* Federal programs should be charged for the actual net cost or net cash disbursed. The phrase "net of applicable credits" refers to credits that normally offset or reduce cost categories as, for example, rental income, sale of assets purchased with grant funds, fees from sale of goods, trade-ins, volume discounts, refunds and other credits, and trade or cash discounts.

22.16 *Were only costs applicable to federal financial assistance programs charged?* In determining properly chargeable costs, generally both direct and indirect, OMB Circular A-87 requires that the following factors be considered: reasonableness, allocability, the application of appropriate GAAP, and any limitations or exclusions set forth in the federal assistance agreement relating to types or amounts charged. Within the federal government, a cost is assignable or chargeable to a particular cost objective (grant, contract, project, activity, process, or service) based on (a) a direct charge according to the benefits received or other equitable relationship, (b) an allocation that may benefit more than one cost objective, or (c) indirect allocation to all cost objectives, since a direct relationship to any particular cost objective cannot be shown though the cost is necessary to the overall operations of the organization. OMB Circular A-87 requires that programs be charged with only those costs applicable to that program.

22.17 *Were the charges properly recorded (that is, correct purpose, amount, date) and supported by source documentation?* To determine whether recorded charges are supported by source documentation, the auditor should examine the evidential matter supporting the charge selected for testing. Documentation should support that the type of cost is allowable under and within the period of the federal financial assistance, that the purpose and the amount of costs are proper (itemized to the extent necessary), and that all approvals are in accordance with management's directives.

22.18 *Were the charges approved in advance, if subject to prior approval in accordance with Circular A-87?* OMB Circular A-87 indicates that prior approval is required for several specific types of expenditures, such as rental cost, capital expenditures, insurance, and professional services. In addition, the federal financial assistance agreement, itself, may require advance approval for other specific costs.

22.19 *Were the charges incurred in accordance with competitive purchasing procedures, if covered by Attachment O of OMB Circular A-102?* Attachment O relates to procurement standards and establishes standards and guidelines for the procurement of supplies, equipment, construction, and services for federal assistance programs and provides for procurement by small-purchase procedures, competitive negotiation, or noncompetitive negotiation.

22.20 *Were the charges allocated equitably to benefiting activities, including nonfederal activities?* The entity should apply the provisions of OMB Circular A-87 for allocating indirect costs benefiting federal and nonfederal activities. A later section on indirect costs describes additional factors relating to the allocation of indirect costs.

Nonmajor Assistance Program Testing

22.21 The Single Audit Act requires that if transactions from nonmajor programs are selected for testing in any part of the tests and reviews performed in connection with the audit of the general purpose or basic financial statements or the study and evaluation of internal controls, such transactions should be tested also for compliance with federal laws and regulations that apply to such transactions. However, such tests need only relate to the previously identified specific program compliance matters and need not address the general compliance identified. For example:

- If in the audit of the general purpose or basic financial statements an auditor examined a payroll transaction that was charged to a nonmajor program, the auditor should determine that the position could reasonably be charged to that program, and that the individual's salary was correctly charged to that program. The auditor is not required to test for general compliance such as compliance with the Hatch Act.

- If, during the audit of the entity's disbursements, the auditor examined a travel claim that was charged to a nonmajor program, the auditor should examine evidence indicating whether the person who performed the travel worked on the program, whether the purpose of the travel was related to the program, whether administrative travel was an allowable charge to the program, and whether the travel allowances were within administratively prescribed limits. The auditor would not be required to test the transactions for general compliance, such as with relocation or cash management limitations.
- If the auditor examined a program-related payment made directly to an individual or organization, the auditor should determine whether the payment was for the purpose intended by the program and for allowed services and whether the individual or organization was eligible. The auditor would not be required to test for general compliance, such as civil rights and cash management.

22.22 In the event that an entity has no major federal financial assistance programs, as defined in the Single Audit Act, the only compliance transaction testing required by the Single Audit Act is that relating to the nonmajor federal financial assistance programs previously described. Also, the auditor should study and evaluate the system of internal controls (accounting and administrative) used in administering the nonmajor federal financial assistance programs as described in chapter 21.

Pass-through Awards

22.23 The Single Audit Act and Circular A-128 require that state government redistributions of federal financial assistance to local governments, known as "pass-through awards," be treated by the local recipient as though they were received directly from the federal government. The recipient of a pass-through award is in effect a subrecipient. Accordingly, pass-through awards should be included in tests on the same basis as federal financial assistance programs received directly.

Review of Federal Financial Reports

22.24 In connection with tests of compliance with applicable laws and regulations, OMB Circular A-128 states "the auditor shall determine whether the federal financial reports and claims for advances and reimbursements contain information that is supported by the books and records from which the [general purpose or] basic financial statements have been prepared...." OMB's *Compliance Supplement* requires the auditor to determine if the federal financial reports are presented in accordance with Attachment H, "Financial Reporting Requirements," to OMB Circular A-102. On a test basis, the auditors should trace major federal program transactions from the accounting records to the federal financial reports. In addition, they should trace the information contained in the federal financial reports to the accounting records on a test basis.

22.25 Attachment H describes the following reports that should be prepared by recipients and submitted to the federal government:

- Financial status report
- Federal cash-transactions report
- Request for advance or reimbursement
- Outlay report and request for reimbursement for construction programs

22.26 Individual federal financial assistance agreements contain the specific reporting requirements the recipient is required to follow. However, Attachment H establishes the standard financial reporting requirements for all federal financial assistance programs. Auditors should become familiar with the detailed instructions and the recipient government's system for preparing and submitting federal financial reports.

Indirect Costs

22.27 A portion of the recipient's operating costs may be charged to federal and other grant programs in the form of indirect costs. The cost principles governing the allowability of costs under government awards, both direct and indirect costs, are set forth in OMB Circular A-87. A synopsis of Circular A-87 is included in Appendix C to this guide.

22.28 Indirect costs are defined as (1) those costs incurred for a common or joint purpose benefiting more than one project, award, contract, or cost objective and (2) those not readily directly assignable to cost objectives specifically benefited. Indirect costs may apply to other departments within the organization in supplying goods, services, and facilities. In addition, minor direct costs may be considered to be indirect costs for practical reasons.

22.29 To be eligible for reimbursement under federal programs, indirect costs must be allocated in conformity with an indirect cost allocation plan prepared in accordance with OMB Circular A-87 or other similar OMB directives. In rare cases where indirect costs cannot be allocated equitably, the federal grantor agency may provide for a negotiated indirect rate in lieu of allocated indirect costs. Also, for services provided by state or local agencies other than the grantee agency, a standard rate for direct labor may be allowed in lieu of computing actual indirect costs.

22.30 All state and many large local governments are required to submit their indirect cost plans to a designated federal indirect cost cognizant agency for approval. Most local governments are not required to submit their indirect cost plans to a cognizant agency for approval; however, an indirect cost cognizant agency may request them.

22.31 The auditor should consider examining supporting documentation to determine whether—

- The costs, bases, and methods of allocating costs are in accordance with guidelines provided in OMB Circular A-87 or a plan that has been approved by the federal government.
- The same costs are not treated both as indirect costs and charged directly to projects.
- Statistical data, for example, square footage, population, and salaries, included in the bases are current and reasonable.
- The costs are reasonable in amount and they are properly allocable.
- The costs were incurred within the period under review.

22.32 If the auditor detects errors in an indirect cost plan, those errors should be discussed with the appropriate level of management. Such errors may include, but are not limited to, mathematical inaccuracies, improper application of cost accounting practices, other factors affecting the calculated indirect cost rate, or misuse of facts that existed at the time the plan was prepared.

22.33 A deficient indirect cost plan or errors in the application of indirect cost principles could materially affect a major federal financial assistance program, or federal financial reports if indirect costs are charged to the award. Such deficiencies or errors, including their effect on the programs, should be included in the schedule of findings and questioned costs accompanying the auditor's compliance report.

Criteria for Reporting Questioned Costs

22.34 The criteria established for questioning costs to be reported in the compliance report vary from one agency to another. Many of the criteria are imposed by Congress at the time the programs are authorized and funds are provided; other criteria are established through agency regulations. Generally, the criteria for reporting questioned costs relate to the following:

- *Unallowable Costs.* Certain costs are specifically unallowable under the general and special award conditions or agency instructions. (They include, but are not limited to, pregrant and post-grant costs and costs in excess of the approved grant budget either by category or in total.)
- *Undocumented Costs.* Costs charged to the grant for which adequate detailed documentation does not exist, for example, to demonstrate their relationship to the grant or the amounts involved.
- *Unapproved Costs.* Costs that are not provided for in the approved grant budget, or costs for which the grant or contract provisions or applicable cost principles require the awarding agency's approval, but for which the auditor finds no evidence of approval.
- *Unreasonable Costs.* Costs incurred that may not reflect the actions that a prudent person would take in the circumstances, or assigning an unreasonably high valuation to in-kind contributions.

22.35 The auditor should review prior audit reports and other related correspondence to determine the nature of previous findings and questioned costs and the status of unresolved issues.

22.36 The Single Audit Act and OMB Circular A-128 do not require that the auditor's report on compliance include a projection of questioned costs to the universe of federal financial assistance programs, nor do they require that the auditor expand the scope of an audit to determine with greater precision the effect of any questioned costs. However, there may be instances in which the circumstances of specific questioned costs could be the basis for the auditor, the grantor, or both, to question all costs charged to a federal program or programs. For example, if eligibility requirements or matching or cost-sharing conditions have not been met by the recipient, the entire amount expended in connection with affected programs may be questioned. If such questioned costs are subsequently disallowed by the federal agency, the entire amount may be required to be refunded by the recipient. If the recipient has not recorded or disclosed a liability or contingent liability for such refunds, the auditor should consider the effect of the liability or contingent liability on the general purpose or basic financial statements. FASB Statement No. 5, *Accounting for Contingencies*, as amended and interpreted, provides guidance on accruing and disclosing contingent liabilities.

22.37 The auditor is required to report questioned costs for grantor agency disposition. The designation by the auditor of a cost as questioned does not necessarily mean that a federal grantor agency will disallow the cost. In most instances the auditor will be unable to determine whether a federal grantor agency will ultimately disallow a questioned cost because the grantor has considerable discretion in these matters. The nature of the questioned costs, as well as the amount involved, will be considered by the grantor in deciding whether to disallow questioned costs. Most federal grantor agencies have established appeal and adjudication procedures.

Client Representations

22.38 GAAS require the auditor to obtain written representations from management. For single audits, those representations should include not only management's representations concerning the identification of federal financial assistance received as included in the schedule of federal financial assistance but also representations as to their compliance with applicable laws and regulations. Management's representations should include identification of known instances of noncompliance.

Audit Sampling

22.39 SAS No. 39, *Audit Sampling*, discusses the factors to be considered in planning, designing, and evaluating audit samples. In addition, the AICPA Audit and Accounting Guide, *Audit Sampling*, provides detailed guidance to assist auditors in implementing SAS No. 39. Both documents discuss the use of audit sampling for tests of compliance with internal accounting controls and for substantive tests of details of account balances or classes of transactions.

22.40 Auditors conducting financial and compliance audits of state or local governmental units generally use audit sampling to perform four types of tests:

- Compliance tests of internal accounting control procedures that the auditor plans to rely on in restricting the scope of planned substantive tests

- Substantive tests as part of the examination of the entity's general purpose or basic financial statements in accordance with GAAS
- Compliance tests to provide reasonable assurance that internal control (accounting and administrative) procedures used in administering federal financial assistance programs are being applied as prescribed
- Substantive tests of compliance with laws and regulations as part of the examination of the general purpose or basic financial statements and for the purpose of reporting on compliance with laws and regulations as they relate to the schedule of federal financial assistance

22.41 The guidance provided by SAS No. 39 and the Audit and Accounting Guide, *Audit Sampling*, discusses audit sampling only within the context of materiality as it relates to the examination of financial statements taken as a whole. In conducting an audit under the requirements of the Single Audit Act, for purposes of federal financial assistance program reporting on substantial compliance with laws and regulations, the level of materiality relates to each major federal financial assistance program.

22.42 Though the Single Audit Act does not require statistical sampling, it does require that a representative number of transactions be selected from each major federal financial assistance program. Auditors should use professional judgment in determining methods of sample selection.

Chapter 23

Single Audit Reports

23.1 As stated in Chapter 17, the Single Audit Act and OMB Circular A-128 require the auditor to issue—

For the entity:

- A report on an examination of the general purpose or basic financial statements of the entity as a whole, or the department, agency, or establishment covered by the audit
- A report on internal accounting control based solely on a study and evaluation made as a part of the audit of the general purpose or basic financial statements
- A report on compliance with laws and regulations that may have a material effect on the financial statements

For its federal financial assistance programs:

- A report on a supplementary schedule of the entity's federal financial assistance programs, showing total expenditures for each federal assistance program
- A report on compliance with laws and regulations identifying all findings of noncompliance and questioned costs
- A report on internal controls (accounting and administrative) used in administering federal financial assistance programs
- A report on fraud, abuse, or an illegal act, or indications of such acts, when discovered (a written report is required); normally, such reports are issued separately

23.2 The recipient is required to provide the auditor's report on the general purpose or basic financial statements, and the auditor's internal control and compliance reports to each federal agency that provides federal financial assistance. In addition, the recipient must submit a plan for corrective action taken or planned and comments on the status of corrective action taken on prior findings.

23.3 Though the required reports may be issued simultaneously to the recipient, that will often not be practicable and the auditor should consider this when planning the audit. Further, it may be possible to merge the several similar reports and thereby only issue three reports—financial, compliance, and internal control. However, many clients and auditors may prefer to issue the reports separately because the client may not wish to include in its annual report a report that makes reference to special-purpose grant auditing and related compliance and internal control matters. (Illustrative reports are provided in Appendix A.)

23.4 Circular A-128 requires that—

- The reports shall be made available by the state or local government for public inspection within thirty days after the completion of the audit.
- Reports shall be submitted by the auditor to the organization audited and to those requiring or arranging for the audit. In addition, the recipient shall submit copies of the reports to each federal department or agency that provided federal assistance funds to the recipient. Subrecipients shall submit copies to recipients that provided them federal assistance funds. The reports shall be sent within thirty days after the completion of the audit, but no later than one year after the end of the audit period, unless a longer period is agreed to with the cognizant agency.

23.5 If separate auditor's reports constitute the single-audit reporting package, the thirty-day provision generally means within thirty days following the date that appears on the *last* required auditor's report received by the recipient.

Supplementary Schedule of Federal Financial Assistance Program Expenditures

23.6 OMB Circular A-128 requires an auditor's report on a schedule of federal financial assistance program expenditures. The schedule of federal financial assistance must show the total expenditures for each federal financial assistance program as identified in the *Catalog of Federal Domestic Assistance* (CFDA). Significant federal financial assistance programs that have not been assigned a catalog number should be identified separately under the caption "other federal assistance." The supplementary schedule should list all federal financial assistance programs, both major and nonmajor, administered by the governmental unit to facilitate identification by an agency of its federal financial assistance programs.

23.7 The information that should be presented for each program includes—

- Identification of each program as it is identified in the CFDA (normally by program or grant title, including the federal agency and federal CFDA number).
- Other federal assistance (federal programs that have not been assigned a catalog number).
- Total expenditures for each federal financial assistance program by grantor, department, or agency.
- Total federal financial assistance.

23.8 Depending on the circumstances of the engagement and the requirements of federal program managers and others, if deemed appropriate, the schedule may also present other information for each program, such as the following:

- Matching contributions
- Amount of the program award
- Receipts or revenue recognized
- Beginning and ending balances, such as unexpended amounts or accrued (deferred) amounts
- Reconciliations to the financial statements, if necessary

23.9 The financial information included in the schedule should be derived from the entity's books and records from which the general purpose or basic financial statements were prepared. It should be prepared as far as practicable on a basis consistent with other federal grant reports. However, the schedule's data may not fully agree with other grant reports because, among other factors—

- The grant reports may be prepared on a different fiscal period, or
- The grant reports may include cumulative (from prior years) rather than only current-year data.

23.10 Because the information presented in the schedule is to be presented on a basis consistent with other federal grant reports, it may not agree with the basis of accounting used to prepare the entity's financial statements. Though a reconciliation should be possible, it is not expected that the schedule's data will be directly agreeable or traceable to the entity's financial statements, because grant activity is usually not separately identifiable in the fund type and account group presentation used in the general purpose or basic financial statements.

23.11 Subrecipients of federal financial assistance should identify program funds that are received directly from the federal government and those program funds received as passthroughs from another governmental unit. For those funds received from another government, the program identifying number(s) (as well as the federal CFDA number) should be included.

23.12 Because federal agencies are the primary users of the supplementary schedule, financial data for state and other nonfederal assistance are not usually presented in the schedule. If such nonfederal data are presented in the schedule, the auditor should discuss the form of presentation with his client.

23.13 Exhibit 23-1, on pages 196-197, provides an illustration of a schedule of federal financial assistance that incorporates the described levels of disclosures.

Required Reports

General Concepts

23.14 Several comments are appropriate with respect to the required compliance report because this report represents a requirement not previously encountered by many auditors.

23.15 *Scope*. The scope paragraph of the auditor's compliance report is limited to the financial and compliance elements of the Standards for Audit issued by the GAO. This limitation is designed to indicate clearly that an expanded scope audit of economy, efficiency, and program results contemplated by the Standards for Audit issued by the GAO is not required by the Single Audit Act.

23.16 *Findings of noncompliance*. Findings of noncompliance are generally listed in a schedule that also identifies the dollar amount of questioned costs. Those costs are amounts expended not in compliance with the terms and conditions of the assistance agreements and regulations. In reporting noncompliance, auditors should place their findings in proper perspective. The extent of noncompliance should be related to the number of cases examined and the dollar amount questioned in order to give the reader a basis for judging the prevalence of noncompliance. The auditor's report on compliance should contain a summary of all instances (findings) of noncompliance and should identify total amounts questioned, if any, for each federal financial assistance award (grant). Some cognizant agencies have requested auditors to list the number and dollar amounts of items tested and the total universe. The use of a table may be appropriate to summarize extensive findings. In presenting the findings the auditor should follow Chapter VII, sections D and E, of the Standards for Audit issued by the GAO. That guidance suggests that well-developed findings that provide sufficient information to federal, state, and local officials to permit timely and corrective action generally consist of statements of the conditions (what is), criteria (what should be), effect (difference between what is and what should be), and cause (why it happened). However, the auditor may not be able to fully develop all of these points, given the scope and purpose of single audits. Findings may also include the pertinent views of responsible officials. Normally, those views would be presented in the recipient's comments on the auditor's findings and recommendations in accordance with paragraph 13 d. of OMB Circular A-128. Where feasible and practicable, the auditor may wish to include recommendations for correcting procedural weaknesses. Findings may also serve as a basis for a federal agency's conducting or contracting for additional audit work. (Appendix A, example 21, illustrates the reporting of instances of noncompliance.) As described in the Standards for Audit issued by the GAO, a status of unresolved recommendations included in prior reports should be disclosed by referring to previous reports.

Auditors' Reports

23.17 *Report on General Purpose Financial Statements*. This report has been discussed in chapter 18 of this guide and is illustrated in Appendix A.

23.18 *Report on Supplementary Information, Schedule of Federal Financial Assistance*. The type of report that should be issued on the Schedule of Federal Financial Assistance is discussed in SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor Submitted Documents*, and is referred to as a report on supplementary information. The report makes specific reference to the examination having been performed in accordance with the standards for financial and compliance audits contained in the Standards for Audit issued by the GAO to meet the requirements of OMB Circular A-128. Example 15 of Appendix A provides an illustration of this type of report.

23.19 *Compliance Report—Based on an Examination of General Purpose or Basic Financial Statements Performed in Accordance With the Standards for Audit Issued by the GAO.* The report on compliance with laws and regulations is required to satisfy the federal audit requirements as specified in the Standards for Audit issued by the GAO. Appendix A, example 16, illustrates such a report issued by an auditor in conjunction with an examination of the general purpose or basic financial statements.

23.20 The report is structured to identify occurrences of noncompliance with federal, state, or local laws and regulations that are material in relation to the general purpose or basic financial statements, and should express positive assurance on items tested and negative assurances on items not tested.

23.21 *Compliance Reports—Based on an Examination of the General Purpose or Basic Financial Statements and the Additional Tests Required by the Single Audit Act.* Examples 17 and 18 of Appendix A illustrate the reports issued when the additional compliance testing of federal financial assistance programs has been performed in accordance with the Single Audit Act. The scope paragraph of these opinions has been further expanded to refer to the other applicable audit guidance. Example 17, *Report on Compliance With Laws and Regulations Related to Major and Nonmajor Federal Financial Assistance Programs*, relates to major and nonmajor federal financial assistance programs and includes an opinion on compliance with laws and regulations for major programs and positive assurance with respect to items tested and negative assurance with respect to items not tested for nonmajor programs.

23.22 Example 18, *Report on Compliance With Laws and Regulations Related to Nonmajor Federal Financial Assistance Programs in Circumstances in Which the Recipient Received No Major Program Funding*, addresses compliance with laws and regulations; it expresses positive assurance concerning items tested, if any, and negative assurance concerning items not tested. This report would be issued separately only in those circumstances in which the organization has only nonmajor programs as defined by the Single Audit Act.

23.23 *Internal Accounting Controls—Based Solely on a Study and Evaluation Made as a Part of an Examination of the General*

Purpose or Basic Financial Statements. This report, an example of which is provided in Appendix A, example 19, is prepared in accordance with SAS No. 30, paragraph No. 49, and accordingly, does not express an opinion on accounting controls but rather is limited to reporting material weaknesses identified. The report includes the special requirements of the Standards for Audit issued by the GAO that are applicable if this report is intended to meet the internal control reporting requirements of the Single Audit Act relating to the audit of the general purpose or basic financial statements. Accordingly, it refers to the entity's control cycles and further identifies those control cycles that were evaluated by the auditors, those that were not, and an explanation as to why they were not reviewed. It should be noted that though modified to incorporate GAO requirements, the report continues to be limited to reporting material weaknesses in relation to the general purpose or basic financial statements.

23.24 *Internal Controls (Accounting and Administrative)—Based on a Study and Evaluation Made as a Part of an Examination of the General Purpose or Basic Financial Statements and the Additional Tests Required by the Single Audit Act.* The auditor should be alert to the fact that this report is required to cover both accounting and administrative controls used to administer federal financial assistance programs. Further, in contrast with the report on internal accounting control resulting from the examination of the general purpose or basic financial statements, the evaluations required to issue this report may *not* exclude any accounting or administrative control systems used to administer federal financial assistance programs. Appendix A, example 20, illustrates the report that is issued when the additional internal control evaluations required by the Single Audit Act are performed. This report should be prepared in accordance with the criteria set forth in SAS No. 30, paragraphs 60-61.

Combined Reporting

23.25 As previously noted in this chapter, it may be feasible in some circumstances to combine the reports issued to comply with the Single Audit Act reporting requirements. Auditors should exercise care in combining such reports to assure that the many unique reporting requirements of the Single Audit Act are preserved in the combined reports.

Exhibit 23-1

EXAMPLE GOVERNMENT
SCHEDULE OF FEDERAL FINANCIAL ASSISTANCE
FOR THE YEAR ENDED JUNE 30, 19XX

Federal Grantor/Pass-Through Grantor/ Program Title[1]	*Federal CFDA Number*[2]	*Pass-Through Grantor's Number*	*Program or Award Amount*	*Cash/ Accrued or (Deferred) Revenue at July 1, 19XX*	*Receipts or Revenue Recognized*	*Disburse-ments/ Expen-ditures*	*Cash/ Accrued or (Deferred) Revenue at June 30, 19XX*[3]
				Beginning Balance at July 1, 19XX			Ending Balance at June 30, 19XX
U.S. Department of Education							
Direct Programs:							
Impact Aid	84.041	N/A	X,XXX,XXX	XX,XXX	X,XXX,XXX	X,XXX,XXX	XX,XXX
Bilingual Education	84.003	N/A	X,XXX,XXX	XX,XXX	X,XXX,XXX	X,XXX,XXX	XX,XXX
				XX,XXX	X,XXX,XXX	X,XXX,XXX	XX,XXX
Passed Through State Department of Education:							
Chapter 1	84.011	XXXXX	X,XXX,XXX	XX,XXX	X,XXX,XXX	X,XXX,XXX	XX,XXX
Chapter 2	84.151	XXXXX	X,XXX,XXX	XX,XXX	X,XXX,XXX	X,XXX,XXX	XX,XXX
Vocational Ed.-Basic Grants to States	84.048	XXXXX	X,XXX,XXX	XX,XXX	X,XXX,XXX	X,XXX,XXX	XX,XXX
				XX,XXX	X,XXX,XXX	X,XXX,XXX	XX,XXX
TOTAL DEPARTMENT OF EDUCATION				XX,XXX	X,XXX,XXX	X,XXX,XXX	XX,XXX

U.S. Department of HUD							
Direct Programs:							
Comm. Dev. Block Grant-Entitlement	14.218	N/A	X,XXX,XXX	XX,XXX	X,XXX,XXX	X,XXX,XXX	XX,XXX
Urban Development Action Grant	14.221	N/A	X,XXX,XXX	(X,XXX)	0	0	(X,XXX)[4]
				XX,XXX	X,XXX,XXX	X,XXX,XXX	XX,XXX
Passed Through State Department of Community Development:							
Comm. Dev. Block Grant-States Prog.	14.219	XXXXX	X,XXX,XXX	XX,XXX	X,XXX,XXX	X,XXX,XXX	XX,XXX
Total U.S. Department of HUD				XX,XXX	X,XXX,XXX	X,XXX,XXX	XX,XXX
Other Federal Assistance[5]							
Department of Defense							
Engineering Study Contract	—	—	X,XXX,XXX	XX,XXX	X,XXX,XXX	X,XXX,XXX	XX,XXX
TOTAL FEDERAL ASSISTANCE				XX,XXX	X,XXX,XXX	X,XXX,XXX	XX,XXX

Notes

(1) All major and nonmajor programs should be individually identified, including those completed or terminated during the audit period.

(2) Catalog of Federal Domestic Assistance number.

(3) If the schedule is prepared on a basis of accounting other than GAAP, the basis should be disclosed. A reconciliation to the general purpose financial statements may be provided.

(4) This item is intended to show that programs can be open without monies being received or expended during the audit period. Such programs should be included in the schedule.

(5) For significant programs or grants that have not been assigned a CFDA number, those programs or grants should be identified separately.

This schedule may be expanded to show local government identifying numbers, matching contributions, and other information. The schedule may also show information by individual grant, with columns added for grant number and grant period.

Appendix A

Illustrative Auditor's Reports on Basic or General Purpose Financial Statements

The following sample auditor's reports illustrate the types of reports to be issued in selected situations. Chapters 18 and 23 include discussions of the selected situations and resulting sample auditor's reports contained in this appendix. For additional guidance the auditor should refer to *Statements on Auditing Standards*.

Example

1. Unqualified Opinion on General Purpose or Component Unit Financial Statements Only
2. Unqualified Opinion on General Purpose or Component Unit Financial Statements Presented Together With Combining, Individual Fund, and Account Group Financial Statements and Supporting Schedules as Supplementary Data
3. Unqualified Opinion on General Purpose or Component Unit Financial Statements and Combining, Individual Fund, and Account Group Financial Statements Presented Together With Supporting Schedules Reported on as Supplementary Data
4. Unqualified Opinion on Component Unit Financial Statements of an Oversight Unit That Omit the Financial Statements of All Other Component Units
5. Qualified Opinion on General Purpose Financial Statements That

Omit One or More, but Not All, Component Units of the Reporting Entity

6. Qualified Opinion on General Purpose or Component Unit Financial Statements That Omit a Fund Type or Account Group
7. Qualified Opinion on General Purpose or Component Unit Financial Statements That Omit a Fund From a Fund Type
8. Unqualified Opinion on General Fund Financial Statements With a Middle Paragraph Calling Attention to the Fact That the Financial Statements Do Not Represent the Financial Position and Results of Operations of the Governmental Unit
9. Unqualified Opinion on an Enterprise Fund's Financial Statements With a Middle Paragraph Calling Attention to the Fact That the Financial Statements Do Not Represent the Financial Position and Results of Operations of the Governmental Unit
10. Qualified Opinion on General Purpose or Component Unit Financial Statements When a Question Arises About the Ability of a Governmental Unit to Meet Its Debts as They Come Due
11. Qualified Opinion on General Purpose Financial Statements That Include an Unaudited Organization, Function, or Activity
12. Unqualified Opinion on General Purpose Financial Statements With Reference to Audit of Part of a Fund Type by Another Auditor
13. Unqualified Opinion on General Purpose Financial Statements With Reference to Audit of All of a Fund Type by Another Auditor
14. Report on Financial Statements Prepared in Accordance With a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles
15. Report on Supplementary Information Schedule of Federal Financial Assistance
16. Compliance Report Based on an Examination of General Purpose or Basic Financial Statements Performed in Accordance With the Standards for Audit Issued by the GAO
17. Report on Compliance With Laws and Regulations Related to Major and Nonmajor Federal Financial Assistance Programs
18. Report on Compliance With Laws and Regulations Related to Nonmajor Federal Financial Assistance Programs in Circumstances in Which the Recipient Received No Major Program Funding
19. Report on Internal Accounting Controls Based Solely on a Study and Evaluation Made as a Part of an Examination of the General Purpose or Basic Financial Statements
20. Report on Internal Controls (Accounting and Administrative)—Based on a Study and Evaluation Made as a Part of an Examination of the General Purpose or Basic Financial Statements and the Additional Tests Required by the Single Audit Act
21. City of Example, Any State—Schedule of Findings and Questioned Costs

Example 1
Auditor's Report

Unqualified Opinion on General Purpose or Component Unit Financial Statements Only

We have examined the general purpose* financial statements of the City of Example, Any State, as of and for the year ended June 30, 19XX, as listed in the table of contents. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the general purpose* financial statements referred to above present fairly the financial position of the City of Example, Any State, at June 30, 19XX, and the results of its operations and the changes in financial position of its proprietary fund types for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

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*If the financial statements are for a component unit, the term "general purpose financial statements" should not be used. In the case of a component unit other than the oversight unit, the term "component unit financial statements" or just "financial statements" should be used. For the component unit financial statements of an oversight unit, see example 4.

Example 2
Auditor's Report

Unqualified Opinion on General Purpose or Component Unit Financial Statements Submitted Together With Combining, Individual Fund, and Account Group Financial Statements and Supporting Schedules as Supplementary Data

We have examined the general purpose* financial statements of the City of Example, Any State, as of and for the year ended June 30, 19XX, as listed in the table of contents. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion the general purpose* financial statements referred to above present fairly the financial position of the City of Example, Any State, at June 30, 19XX, and the results of its operations and the changes in financial position of its proprietary fund types for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Our examination was made for the purpose of forming an opinion on the general purpose* financial statements taken as a whole. The combining, individual fund, and individual account group financial statements and schedules listed in the table of contents are presented for purposes of additional analysis and are not a required part of the general purpose financial statements of the City of Example, Any State. Such information has been subjected to the auditing procedures applied in the examination of the general purpose* financial statements and, in our opinion, is fairly stated in all material respects in relation to the general purpose* financial statements taken as a whole.

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*If the financial statements are for a component unit, the term "general purpose financial statements" should not be used. In the case of a component unit other than the oversight unit, the term "component unit financial statements" or just "financial statements" should be used. For the component unit financial statements of an oversight unit, see example 4.

Example 3
Auditor's Report

Unqualified Opinion on General Purpose or Component Unit Financial Statements and Combining, Individual Fund, and Account Group Financial Statements Presented Together With Supporting Schedules Reported on as Supplementary Data

We have examined the general purpose* financial statements of the City of Example, Any State, and the combining, individual fund, and account group financial statements of the City as of and for the year ended June 30, 19XX, as listed in the table of contents. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the general purpose* financial statements referred to above present fairly the financial position of the City of Example, Any State, at June 30, 19XX, and the results of its operations and the changes in financial position of its proprietary fund types for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year. Also, in our opinion, the combining, individual fund, and account group financial statements referred to above present fairly the financial position of each of the individual funds and account groups of the City of Example, Any State, at June 30, 19XX, and the results of operations of such funds and the changes in financial position of individual proprietary funds for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Our examination was made for the purpose of forming an opinion on the general purpose* financial statements taken as a whole and on the combining, individual fund, and individual account group financial statements. The accompanying financial information listed as supporting schedules in the table of contents is presented for purposes of additional analysis and is not a required part of the financial statements of the City of Example, Any State. Such information has been subjected to the auditing procedures applied in the examination of the general purpose,* combining, individual fund, and individual account group financial statements and, in our opinion, is fairly stated in all material respects in relation to the financial statements of each of the respective individual funds and account groups, taken as a whole.

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*If the financial statements are for a component unit, the term "general purpose financial statements" should not be used. In the case of a component unit other than the oversight unit, the term "component unit financial statements" or just "financial statements" should be used. For the component unit financial statements of an oversight unit, see example 4.

Example 4
Auditor's Report

Unqualified Opinion on Component Unit Financial Statements of an Oversight Unit That Omit the Financial Statements of All Other Component Units

We have examined the component unit financial statements of the City of Example, Any State, oversight unit as of and for the year ended June 30, 19XX, as listed in the table of contents. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The financial statements referred to above include only the financial activities of the oversight unit. Financial activities of other component units that form the reporting entity are not included.

In our opinion, the component unit financial statements referred to above present fairly the financial position of City of Example, Any State, oversight unit, at June 30, 19XX, and the results of its operations and the changes in financial position of its proprietary fund types for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Example 5
Auditor's Report

Qualified Opinion on General Purpose Financial Statements That Omit One or More, but Not All, Component Units of the Reporting Entity

We have examined the general purpose financial statements of the City of Example, Any State, as of and for the year ended June 30, 19XX, as listed in the table of contents. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The general purpose financial statements referred to above do not include financial activities of the [*identify the component unit omitted*], which should be included to conform with generally accepted accounting principles. If the omitted component unit had been included,* the assets and revenues of the [*identify fund type(s), e.g., special revenue fund type*] would have increased by $XXX,XXX and $XXX,XXX, respectively, there would have been an excess of expenditures over revenues in that fund type for the year of $XXX,XXX, and the [*identify fund type(s)*] fund balance would have been a deficit of $XXX,XXX.

In our opinion, except for the effects on the financial statements of the omission described in the preceding paragraph, the general purpose financial statements referred to above present fairly the financial position of City of Example, Any State, at June 30, 19XX, and the results of its operations and the changes in financial position of its proprietary fund types for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Note: If the omission was sufficiently material, the auditor should express an adverse opinion on the general purpose financial statements. In such case, the opinion paragraph should state all the substantive reasons for the adverse opinion and the principal effects of those matters.

*If the amounts applicable to the omitted component have not been audited, insert the phrase "based on unaudited information."

Example 6
Auditor's Report

Qualified Opinion on General Purpose or Component Unit Financial Statements That Omit a Fund Type or Account Group

We have examined the general purpose* financial statements of the City of Example, Any State, as of and for the year ended June 30, 19XX, as listed in the table of contents. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The general purpose financial statements referred to above do not include the [*identify the fund type (account group) omitted*], which should be included to conform with generally accepted accounting principles. The omitted fund type** has assets, liabilities, revenues, and expenditures of $XXX,XXX, $XXX,XXX, $XXX,XXX, and $XXX,XXX, respectively. (The amount that should be recorded in the general fixed assets account group is not known.)

In our opinion, except for the effect on the financial statements of the omission described in the preceding paragraph, the general purpose* financial statements referred to above present fairly the financial position of City of Example, Any State, at June 30, 19XX, and the results of its operations and the changes in financial position of its proprietary fund types for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Note: If the omission was sufficiently material, the auditor should express an adverse opinion on the financial statements. In such case, the opinion paragraph should state all the substantive reasons for the adverse opinion and the principal effects of those matters.

*If the financial statements are for a component unit, the term "general purpose financial statements" should not be used. In the case of a component unit other than the oversight unit, the term "component unit financial statements" or just "financial statements" should be used. For the component unit financial statements of an oversight unit, the principles in example 4 should be combined with this example.

**If the amounts applicable to the omitted fund type have not been audited, insert the phrase "based on unaudited information."

Example 7
Auditor's Report

Qualified Opinion on General Purpose or Component Unit Financial Statements That Omit a Fund From a Fund Type

We have examined the general purpose* financial statements of the City of Example, Any State, as of and for the year ended June 30, 19XX, as listed in the table of contents. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The general purpose financial statements referred to above do not include the [*identify the omitted fund*], which should be included to conform with generally accepted accounting principles. If the omitted fund** had been included, the [*identify fund type*] assets, liabilities, revenues, and expenditures would have increased $XXX,XXX, $XXX,XXX, $XXX,XXX, and $XXX,XXX, respectively.

In our opinion, except for the effect on the financial statements of the omission described in the preceding paragraph, the general purpose* financial statements referred to above present fairly the financial position of City of Example, Any State, at June 30, 19XX, and the results of its operations and the changes in financial position of its proprietary fund types for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Note: If the omission was sufficiently material, the auditor should express an adverse opinion on the financial statements. In such case, the opinion paragraph should state all the substantive reasons for the adverse opinion and the principal effects of those matters.

*If the financial statements are for a component unit, the term "general purpose financial statements" should not be used. In the case of a component unit other than the oversight unit, the term "component unit financial statements" or just "financial

statements" should be used. For the component unit financial statements of an oversight unit, the principles in example 4 should be combined with this example.
**If the amounts applicable to the omitted fund have not been audited, insert the phrase "based on unaudited information."

Example 8
Auditor's Report

Unqualified Opinion on General Fund Financial Statements With a Middle Paragraph Calling Attention to the Fact That the Financial Statements Do Not Represent the Financial Position and Results of Operations of the Governmental Unit

We have examined the financial statements of the general fund of the City of Example, Any State, as of and for the year ended June 30, 19XX, as listed in the table of contents. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As described more fully in Note ______, the financial statements present only the general fund and are not intended to present fairly the financial position and results of operations of City of Example in conformity with generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly the financial position of the general fund of the City of Example, Any State, at June 30, 19XX, and the results of that fund's operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Example 9
Auditor's Report

Unqualified Opinion on an Enterprise Fund's Financial Statements With a Middle Paragraph Calling Attention to the Fact That the Financial Statements Do Not Represent the Financial Position and Results of Operations of the Governmental Unit

We have examined the financial statements of the [*identify enterprise fund*] of the City of Example, Any State, as of and for the year ended June 30, 19XX, as listed in the table of contents. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As described more fully in Note ______, the financial statements present only the [*identify enterprise fund*] and are not intended to present fairly the financial position and results of operations of City of Example in conformity with generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly the financial position of the [*identify enterprise fund*] of the City of Example, Any State, at June 30, 19XX, and the results of that fund's operations and the changes in its financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Example 10
Auditor's Report

Qualified Opinion on General Purpose or Component Unit Financial Statements When a Question Arises About the Ability of a Governmental Unit to Meet Its Debts as They Come Due

We have examined the general purpose* financial statements of the City of Example, Any State, as of and for the year ended June 30, 19XX, as listed in the table of contents. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As disclosed in the financial statements, [*include description of reason that a question has arisen about the ability of the governmental unit to meet its debts as they come due*]. The financial statements do not include any adjustment relating to the amounts and classification of liabilities** that might be necessary if the City of Example is not able to meet its debts as they come due or if such debts are adjusted under the provisions of Chapter 9 of the Federal Bankruptcy Code.

In our opinion, subject to the effects on the financial statements of such adjustments, if any, as might have been required had the outcome of the uncertainty about the amount and classification of liabilities referred to in the preceding paragraph been known, the general purpose* financial statements referred to above present fairly the financial position of City of Example, Any State, at June 30, 19XX, and the results of its operations and the changes in financial position of its proprietary fund types for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

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*If the financial statements are for a component unit, the term "general purpose financial statements" should not be used. In the case of a component unit other than the oversight unit, the term "component unit financial statements" or just "financial statements" should be used. For the component unit financial statements of an oversight unit, the principles in example 4 should be combined with this example.

**If the uncertainty includes questions about the recoverability and classification of recorded asset amounts, that fact should be stated and the opinion paragraph modified accordingly.

Example 11
Auditor's Report

Qualified Opinion on General Purpose Financial Statements That Include an Unaudited Organization, Function, or Activity

We have examined the general purpose financial statements of the City of Example, Any State, as of and for the year ended June 30, 19XX, as listed in the table of contents. Except as explained in the following paragraph, our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The general purpose financial statements referred to above include the financial activities of the [*identify the organization, function, or activity*] that are unaudited. Those financial activities are included in the [*identify fund type or account group*] and represent 18 percent and 24 percent of the assets and revenues, respectively, of that fund type.

In our opinion, except for the effects on the financial statements of such adjustments, if any, as might have been determined to be necessary had we audited the financial statements of [*identify the organization, function, or activity*] referred to above, the general purpose financial statements referred to above present fairly the financial position of City of Example, Any State, at June 30, 19XX, and the results of its operations and the changes in financial position of its proprietary fund types for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Example 12
Auditor's Report

Unqualified Opinion on General Purpose Financial Statements With Reference to Audit of Part of a Fund Type by Another Auditor.

We have examined the general purpose financial statements of the City of Example, Any State, as of and for the year ended June 30, 19XX, as listed in the table of contents. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. We did not examine the financial statements of [*identify component unit or fund*], which represent 20 percent and 22 percent, respectively, of the assets and revenues of the [*identify fund type*]. Those financial statements were audited by other auditors whose report thereon has been furnished to us and our opinion expressed herein, insofar as it relates to the amounts included for [*identify component unit or fund*], is based solely upon the report of the other auditors.

In our opinion, based upon our examination and the report of other auditors, the general purpose financial statements referred to above present fairly the financial position of the City of Example, Any State, at June 30, 19XX, and the results of its operations and the changes in financial position of its proprietary fund types for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Example 13
Auditor's Report

Unqualified Opinion on General Purpose Financial Statements With Reference to Audit of All of a Fund Type by Another Auditor.

We have examined the general purpose financial statements of the City of Example, Any State, as of and for the year ended June 30, 19XX, as listed in the table of contents. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. We did not examine the financial statements of [*identify fund type*], which represent the amounts shown as the [*identify fund type*]. Those financial statements were audited by other auditors whose report thereon has been furnished to us and our opinion expressed herein, insofar as it relates to the amounts included for [*identify fund type*], is based solely upon the report of the other auditors.

In our opinion, based upon our examination and the report of other auditors, the general purpose financial statements referred to above present fairly the financial position of the City of Example, Any State, at June 30, 19XX, and the results of its operations and the changes in financial position of its proprietary fund types for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Example 14
Auditor's Report

Report on Financial Statements Prepared in Accordance With a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles

We have examined the financial statements of the individual funds of the City of Example, Any State, as of and for the year ended June 30, 19XX, as listed in the table of contents. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As described in Note ___, the City's policy is to prepare its financial statements on a prescribed basis of accounting that demonstrates compliance with the cash basis and budget laws of Any State. This practice differs from generally accepted accounting principles. Accordingly, the accompanying financial statements are not intended to present financial position and results of operations in conformity with generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly the cash and unencumbered cash balances of each of the various funds of the City of Example, Any State, at June 30, 19XX, and the revenues received and expenditures paid of such funds for the year then ended, on the basis of accounting described in Note ____, which basis has been applied in a manner consistent with that of the preceding year.

Example 15
Auditor's Report

Report on Supplementary Information Schedule of Federal Financial Assistance

We have examined the general purpose financial statements of the City of Example, Any State, for the year ended June 30, 19XX, and have issued our report thereon dated September 21, 19XX. Our examination of such general purpose financial statements was made in accordance with generally accepted auditing standards and the standards for financial and compliance audits contained in the *Standards for Audit of Governmental Organizations, Programs, Activities, and Functions*, issued by the U.S. General Accounting Office, and accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

Our examination was made for the purpose of forming an opinion on the general purpose financial statements taken as a whole. The accompanying Schedule of Federal Financial Assistance is presented for purposes of additional analysis and is not a required part of the general purpose financial statements. The information in that schedule has been subjected to the auditing procedures applied in the examination of the general purpose financial statements and, in our opinion, is fairly stated in all material respects in relation to the general purpose financial statements taken as a whole.

Example 16
Auditor's Report

Compliance Report Based on an Examination of General Purpose or Basic Financial Statements Performed in Accordance With the Standards for Audit Issued by the GAO

We have examined the general purpose[1] financial statements of the City of Example, Any State, for the year ended June 30, 19XX, and have issued our report thereon dated September 21, 19XX. Our examination was made in accordance with generally accepted auditing standards and the standards for financial and compliance audits contained in the *Standards for Audit of Governmental Organizations, Programs, Activities, and Functions*, issued by the U.S. General Accounting Office, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The management of the City of Example is responsible for the City's compliance with laws and regulations. In connection with our examination referred to above, we selected and tested transactions and records to determine the City's compliance with laws and regulations noncompliance with which could have a material effect on the general purpose financial statements of the City.

The results of our tests indicate that for the items tested, the City of Example, Any State, complied with those provisions of laws and regulations noncompliance with which could have a material effect on the general purpose financial statements. Nothing came to our attention that caused us to believe that for the items not tested the City of Example, Any State, was not in compliance with laws or regulations noncompliance with which could have a material effect on the City's general purpose financial statements.[2]

---

1. For reports on basic financial statements the word *basic* would be substituted for *general purpose* throughout the report.
2. If the auditor's testing of compliance with laws and regulations identifies noncompliance with laws and regulations, the last paragraph of the report on compliance should be modified as follows:

> The results of our tests indicate that for the transactions tested the City of Example, Any State, complied with those laws and regulations referred to above, except as described in the attached schedule. Those instances of noncompliance were considered by us in evaluating whether the general purpose financial statements are presented fairly in conformity with generally accepted accounting principles. With respect to the transactions not tested, nothing came to our attention to indicate that the City of Example, Any State, had not complied with laws and regulations other than those laws and regulations for which we noted violations in our testing referred to above.
>
> In the event exceptions are reported as a result of tests performed, the auditor should consider the extent to which the pervasiveness of reported exceptions may affect the auditor's ability to express negative assurance with respect to items not tested.

Example 17
Auditor's Report

Report on Compliance With Laws and Regulations Related to Major and Nonmajor Federal Financial Assistance Programs

We have examined the general purpose financial statements of the City of Example, Any State, for the year ended June 30, 19XX, and have issued our report thereon dated September 21, 19XX. Our examination was made in accordance with generally accepted auditing standards; the standards for financial and compliance audits contained in the *Standards for Audit of*

Governmental Organizations, Programs, Activities, and Functions, issued by the U.S. General Accounting Office; the Single Audit Act of 1984; and the provisions of OMB Circular A-128, *Audits of State and Local Governments* and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The management of the City of Example, Any State, is responsible for the City's compliance with laws and regulations. In connection with the examination referred to above, we selected and tested transactions and records from each major federal financial assistance program and certain nonmajor federal financial assistance programs.[1] The purpose of our testing of transactions and records from those federal financial assistance programs was to obtain reasonable assurance that the City of Example, Any State, had, in all material respects, administered major programs, and executed the tested nonmajor program transactions, in compliance with laws and regulations, including those pertaining to financial reports and claims for advances and reimbursements, noncompliance with which we believe could have a material effect on the allowability of program expenditures.

Our testing of transactions and records selected from major federal financial assistance programs disclosed instances of noncompliance with those laws and regulations. All instances of noncompliance that we found and the programs to which they relate are identified in the accompanying schedule of findings and questioned costs.[2,3]

In our opinion, subject to the effect of the ultimate resolution of those instances of noncompliance referred to in the preceding paragraph,[3] for the year ended June 30, 19XX, the City of Example, Any State, administered each of its major federal financial assistance programs in compliance, in all material respects, with laws and regulations, including those pertaining to financial reports and claims for advances and reimbursements, noncompliance with which we believe could have a material effect on the allowability of program expenditures.

The results of our testing of transactions and records selected from nonmajor federal financial assistance programs indicate that for the transactions and records tested the City of Example, Any State, complied with the laws and regulations referred to in the second paragraph of our report, except as noted in the accompanying schedule of findings and questioned costs. Our testing was more limited than would be necessary to express an opinion on whether the City of Example, Any State, administered those programs in compliance in all material respects with those laws and regulations noncompliance with which we believe could have a material effect on the allowability of program expenditures; however, with respect to the transactions and records that were not tested by us, nothing came to our attention to indicate that the City of Example, Any State, had not complied with laws and regulations other than those laws and regulations for which we noted violations in our testing referred to above.[4]

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1. If, in connection with both the examination of the general purpose financial

statements and the study and evaluation of internal controls used in administering federal financial assistance programs, the auditor selected for testing compliance no transactions from nonmajor federal assistance programs, the auditor would make no reference to testing of such transactions in the report on compliance with laws and regulations.

The auditor should perform his examination with an awareness of the possibility that illegal acts may have occurred. Such awareness and the consideration of all facts that come to his attention during the examination provide the basis for the auditor's expression of negative assurance concerning compliance with laws and regulations in the execution of transactions that the auditor has not tested. Thus, the auditor may provide this negative assurance in situations in which he has not tested any transactions from nonmajor federal financial assistance programs.

2. *The Standards for Audit of Governmental Organizations, Programs, Activities, and Functions,* issued by the U.S. General Accounting Office, states that well-developed findings generally consist of the following (see chapter 23 for further explanation):

- A statement of condition
- The criteria
- The effect
- The cause

It is recognized that the auditor may not be able to fully develop all of these points for each instance of noncompliance given the scope and purpose of single audits. The auditor should attempt to identify the condition, criteria, effect, and cause to provide sufficient information to federal, state, and local officials to permit timely and proper corrective action. These findings may also serve as a basis for a federal agency's conducting or contracting for additional audit work.

3. In the event that the auditor concludes that the ultimate resolution of instances of noncompliance could not have a material effect on the allowability of expenditures of the identified programs, a statement to that effect should be included in the third paragraph and an unqualified opinion issued.

4. If the auditor's testing of transactions selected from either major or nonmajor federal financial assistance programs identifies violations of laws and regulations, the auditor should consider whether the extent of those violations is so pervasive that it would preclude the expression of negative assurance on the entity's compliance with laws and regulations as they apply to the items not tested. If the auditor concludes that the extent of such violations precludes the expression of negative assurance, the last paragraph of the report on compliance should be modified as follows:

> The results of our testing of transactions and records selected from nonmajor federal financial assistance programs indicate that for the transactions and records tested the City of Example, Any State, complied with those laws and regulations referred to above, except as noted in the accompanying schedule of findings and questioned costs. Our testing was more limited than would be necessary to express an opinion on whether the City of Example, Any State, administered those programs in compliance in all material respects with those laws and regulations noncompliance with which we believe could have a material effect on the allowability of program expenditures; however, the extent of noncompliance noted in our testing indicates that, with respect to the transactions that occurred in the administration of nonmajor federal financial assistance programs and that were not tested by us, there is more than a relatively low risk that the City of Example, Any State, may have violated applicable laws and regulations.

Example 18
Auditor's Report

Report on Compliance With Laws and Regulations Related to Nonmajor Federal Financial Assistance Programs in Circumstances in Which the Recipient Received No Major Program Funding

We have examined the general purpose financial statements of the City of Example, Any State, for the year ended June 30, 19XX, and have issued our report thereon dated September 21, 19XX. Our examination was made in accordance with generally accepted auditing standards; the standards for financial and compliance audits contained in the *Standards for Audit of Governmental Organizations, Programs, Activities, and Functions*, issued by the U.S. General Accounting Office; the Single Audit Act of 1984; and the provisions of OMB Circular A-128, *Audits of State and Local Governments*, and accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The management of the City of Example, Any State, is responsible for the City's compliance with laws and regulations. In connection with the examination referred to above, we selected and tested transactions and records from nonmajor federal financial assistance programs to determine the City's compliance with laws and regulations noncompliance with which we believe could have a material effect on the allowability of program expenditures.

The results of our tests indicate that for the transactions and records tested the City of Example, Any State, complied with the laws and regulations referred to above, except as described in the accompanying schedule of findings and questioned costs. Our testing was more limited than would be necessary to express an opinion on whether the City of Example, Any State, administered those programs in compliance in all material respects with laws and regulations noncompliance with which we believe could have a material effect on the allowability of program expenditures; however, with respect to the transactions that were not tested by us, nothing came to our attention to indicate that the City of Example, Any State, had violated laws and regulations other than those laws and regulations for which we noted violations in our testing referred to above.[1]

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1. If the auditor concludes that the extent of such violations precludes the expression of negative assurance, the last paragraph of the report on compliance should be modified as follows:

However, the extent of noncompliance noted in our testing indicates that, with respect to the transactions that occurred in the administration of nonmajor federal financial assistance programs and that were not tested by us, there is more than a relatively low risk that the City of Example, Any State, may have violated applicable laws and regulations.

Example 19
Auditor's Report

Report on Internal Accounting Controls Based Solely on a Study and Evaluation Made as a Part of an Examination of the General Purpose or Basic Financial Statements

We have examined the general purpose financial statements of City of Example, Any State, for the year ended June 30, 19XX, and have issued our report thereon dated September 21, 19XX. As part of our examination, we made a study and evaluation of the system of internal accounting control of City of Example, Any State, to the extent we considered necessary to evaluate the system as required by generally accepted auditing standards and the standards for financial and compliance audits contained in the U.S. General Accounting Office *Standards for Audit of Governmental Organizations, Programs, Activities, and Functions.* For the purpose of this report, we have classified the significant internal accounting controls in the following categories: [*identify control categories*].[1] Our study included all of the control categories listed above (except that we did not evaluate the accounting controls over [*identify any category not evaluated*] because [*state reason for excluding any category from the evaluation*]). The purpose of our study and evaluation was to determine the nature, timing, and extent of the auditing procedures necessary for expressing an opinion on the entity's financial statements. Our study and evaluation was more limited than would be necessary to express an opinion on the system of internal accounting control taken as a whole or on any of the categories of controls identified above.

The management of City of Example, Any State, is responsible for establishing and maintaining a system of internal accounting control. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of control procedures. The objectives of a system are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any system of internal accounting control, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the system to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the degree of compliance with the procedures may deteriorate.

Our study and evaluation made for the limited purpose described in the first paragraph would not necessarily disclose all material weaknesses in the system. Accordingly, we do not express an opinion on the system of internal accounting control of City of Example, Any State, taken as a whole or on any of the categories of controls identified in the first paragraph. However, our study and evaluation disclosed the following conditions that we believe result in more than a relatively low risk that errors or irregularities in amounts that would be material in relation to the financial statements of City of Example, Any State, may occur and not be detected within a timely period. [2] (A description of the material weaknesses that have come to the auditor's attention would follow; if the study and evaluation discloses no material weaknesses, this sentence should state, "However, our study and evaluation disclosed no condition that we believe to be a material weakness," and the following paragraph of this report would be omitted.)

These conditions were considered in determining the nature, timing, and extent of the audit tests to be applied in our examination of the 19XX financial statements, and this report does not affect our report on the financial statements dated September 21, 19XX.

This report is intended solely for the use of management and [*specify legislative or regulatory body*] and should not be used for any other purpose. This restriction is not intended to limit the distribution of this report which, upon acceptance by the [*specify legislative or regulatory body*], is a matter of public record.

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1. The following are examples of different ways in which controls might be classified. The auditor should modify these examples or use other classifications as appropriate for the particular circumstances on which he is reporting.

   A. *Cycles of the Entities' Activity*
   - Treasury or financing
   - Revenue/receipts
   - Purchases/disbursements
   - External financial reporting

   B. *Financial Statement Captions*
   - Cash and cash equivalents
   - Receivables
   - Inventory
   - Property and equipment
   - Payables and accrued liabilities
   - Debt
   - Fund balance

   C. *Accounting Applications*
   - Billings
   - Receivables
   - Cash receipts
   - Purchasing and receiving
   - Accounts payable
   - Cash disbursements
   - Payroll
   - Inventory control
   - Property and equipment
   - General ledger

2. (a) All material weaknesses that have come to the auditor's attention during the audit would be described, whether or not they relate to a category of controls that was excluded from the study and evaluation. Though only material weaknesses in internal controls need be reported, the auditor may wish to report nonmaterial weaknesses to management. This may be accomplished in the auditor's letter to management or through some similar method of communication. If a letter to management is prepared, the auditor should refer to that communication in this report.

(b) *The Standards for Audit of Governmental Organizations, Programs, Activities, and Functions,* issued by the U.S. General Accounting Office, states that well-developed findings concerning material weaknesses in internal controls generally consist of the following (see chapter 23 for further explanation):

- A statement of condition
- The criteria
- The effect
- The cause

It is recognized that the auditor may not be able to fully develop all of these points for each material weakness found, given the scope and purpose of the control study. The auditor should attempt to identify the condition, criteria, effect, and cause to provide sufficient information to federal, state, and local officials to permit timely and proper corrective action. These findings may also serve as a basis for a federal agency's conducting or contracting for additional audit work.

Example 20
Auditor's Report

Report on Internal Controls (Accounting and Administrative) – Based on a Study and Evaluation Made as a Part of an Examination of the General Purpose or Basic Financial Statements and the Additional Tests Required by the Single Audit Act

We have examined the general purpose financial statements of the City of Example, Any State, for the year ended June 30, 19XX, and have issued our report thereon dated September 21, 19XX. As part of our examination, we made a study and evaluation of the internal control systems, including applicable internal administrative controls, used in administering federal financial assistance programs to the extent we considered necessary to evaluate the systems as required by generally accepted auditing standards, the standards for financial and compliance audits contained in the *Standards for Audit of Governmental Organizations, Programs, Activities, and Functions,* issued by the U.S. General Accounting Office, the Single Audit Act of 1984, and the provisions of OMB Circular A-128, *Audits of State and Local Governments.* For the purpose of this report, we have classified the significant internal accounting and administrative controls used in administering federal financial assistance programs in the following categories: [*identify control categories*][1]

The management of the City of Example, Any State, is responsible for establishing and maintaining internal control systems used in administering federal financial assistance programs. In fulfilling that responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of control procedures. The objectives of internal control systems used in administering federal financial assistance programs are to provide management with reasonable, but not absolute, assurance that, with respect to federal financial assistance programs, resource use is consistent with laws, regulations, and policies; resources are safeguarded against waste, loss, and misuse; and reliable data are obtained, maintained, and fairly disclosed in reports.

Because of inherent limitations in any system of internal accounting and administrative controls used in administering federal financial assistance programs, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the systems to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the degree of compliance with the procedures may deteriorate.

Our study included all of the applicable control categories listed above. During the year ended June 30, 19XX, the City of Example, Any State, expended X% of its total federal financial assistance under major federal financial assistance programs. With respect to internal control systems used in administering major federal financial assistance programs, our study and evaluation included considering the types of errors and irregularities that could occur, determining the internal control procedures that should prevent or detect such errors and irregularities, determining whether the necessary procedures are prescribed and are being followed satisfactorily, and evaluating any weaknesses.

With respect to the internal control systems used solely in administering the nonmajor federal financial assistance programs of the City of Example, Any State, our study and evaluation was limited to a preliminary review of the systems to obtain an understanding of the control environment and the flow of transactions through the accounting system. Our study and evaluation of the internal control systems used solely in administering the nonmajor federal financial assistance programs of the City of Example, Any State, did not extend beyond this preliminary review phase.[2]

Our study and evaluation was more limited than would be necessary to express an opinion on the internal control systems used in administering the federal financial assistance programs of the City of Example, Any State. Accordingly, we do not express an opinion on the internal control systems used in administering the federal financial assistance programs of the City of Example, Any State. Further, we do not express an opinion on the internal control systems used in administering the major federal financial assistance programs of the City of Example, Any State.

Also, our examination, made in accordance with the standards mentioned above, would not necessarily disclose material weaknesses in the internal control systems used solely in administering nonmajor federal financial assistance programs.

However, our study and evaluation and our examination disclosed the following conditions that we believe result in more than a relatively low risk that errors or irregularities in amounts that would be material to a federal financial assistance program may occur and not be detected within a timely period.[3] (A description of the conditions that have come to the auditor's attention would follow; if the study and evaluation and the examination disclose no material weaknesses in relation to a federal financial assistance program, this sentence should state, "However, our study and evaluation and our examination disclosed no condition that we believe to be a material weakness in relation to a federal financial assistance program of the City of Example, Any State," and the following paragraph should be omitted.)

These conditions were considered in determining the nature, timing, and extent of the audit tests to be applied in (1) our examination of the 19XX general purpose financial statements and (2) our examination and review of the City's compliance with laws and regulations noncompliance with which we believe could have a material effect on the allowability of program expenditures for each major federal financial assistance program and non-major federal financial assistance programs. This report does not affect our reports on the general purpose financial statements and on the City's compliance with laws and regulations dated September 21, 19XX.

This report is intended solely for the use of management and [*insert name of regulatory agency of other third party*] and should not be used for any other purpose. This restriction is not intended to limit the distribution of this report, which, upon acceptance by the City of Example, Any State, is a matter of public record.

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1. *Accounting Controls*

Following are examples of different ways in which accounting controls might be classified. The auditor should modify these examples or use other classifications as appropriate for the particular circumstances on which he is reporting.

Cycles of the Entities' Activity
- Treasury or financing
- Revenue/receipts
- Purchases/disbursements
- External financial reporting

Financial Statement Captions
- Cash and cash equivalents
- Receivables
- Inventory
- Property and equipment
- Payables and accrued liabilities
- Debt
- Fund balance

Accounting Applications
- Billings
- Receivables
- Cash receipts
- Purchasing and receiving
- Accounts payable
- Cash disbursements
- Payroll
- Inventory control
- Property and equipment
- General ledger

Controls Used in Administering Federal Programs

Following are general and specific administrative control categories identified by representatives of the federal government.

Controls used in administering individual federal financial assistance programs (refer to chapter 22)

General Requirements
- Political activity

- Davis-Bacon Act
- Civil Rights
- Cash management
- Relocation assistance and real property acquisition
- Federal financial reports

Specific Requirements

- Types of services
- Eligibility
- Matching level of effort
- Reporting
- Cost allocation
- Special requirements, if any
- Monitoring subrecipients

2. (a) If total assistance expended under major federal financial assistance programs is greater than zero but constitutes less than 50% of total federal assistance expended by the government during the year under examination, the auditor should apply the guidance in chapter 21 in order to satisfy the objectives of the Single Audit Act. When such guidance is applied, the fourth through seventh paragraphs of the report on internal controls used to administer federal financial assistance programs should be modified as follows:

"Our study included all of the applicable control categories listed above. During the year ended June 30, 19XX, the City of Example, Any State, expended X% of its total federal financial assistance under major federal financial assistance programs and the following nonmajor federal financial assistance programs: [*list appropriate nonmajor federal financial assistance programs*]. With respect to internal control systems used in administering these major and nonmajor federal financial assistance programs, our study and evaluation included considering the types of errors and irregularities that could occur, determining the internal control procedures that should prevent or detect such errors and irregularities, determining whether the necessary procedures are prescribed and are being followed satisfactorily, and evaluating any weaknesses.

"With respect to the internal control systems used solely in administering the other nonmajor federal financial assistance programs of the City of Example, Any State, our study and evaluation was limited to a preliminary review of the systems to obtain an understanding of the control environment and the flow of transactions through the accounting system. Our study and evaluation of the internal control systems used solely in administering these nonmajor federal financial assistance programs of the City of Example, Any State, did not extend beyond this preliminary review phase.

"Our study and evaluation was more limited than would be necessary to express an opinion on the internal control systems used in administering the federal financial assistance programs of the City of Example, Any State. Accordingly, we do not express an opinion on the internal control systems used in administering the federal financial assistance programs of the City of Example, Any State. Further, we do not express an opinion on the internal control systems used in administering the major federal financial assistance programs of the City of Example, Any State.

"Also, our examination, made in accordance with the standards mentioned above, would not necessarily disclose material weaknesses in the internal control systems for which our study and evaluation was limited to a preliminary review of the systems as discussed in the fifth paragraph of this report."

(b) If the government had no major federal financial assistance programs during the year under examination, the auditor should apply the guidance in chapter 21 in order to satisfy the objectives of the Single Audit Act. When such guidance is applied, the fourth through seventh paragraphs of the auditor's report on internal controls used to administer federal financial assistance programs should be modified as follows:

"Our study included all of the applicable control categories listed above. During the year ended June 30, 19XX, the City of Example, Any State, had no major federal financial assistance programs and expended X% of its total federal financial assistance under the following nonmajor federal financial assistance programs: [*list appropriate nonmajor federal financial assistance programs*]. With respect to internal control systems used in administering these nonmajor federal financial assistance programs, our study and evaluation included considering the types of errors and irregularities that could occur, determining the internal control procedures that should prevent or detect such errors and irregularities, determining whether the necessary procedures are prescribed and are being followed satisfactorily, and evaluating any weaknesses.

"With respect to the internal control systems used solely in administering the other nonmajor federal financial assistance programs of the City of Example, Any State, our study and evaluation was limited to a preliminary review of the systems to obtain an understanding of the control environment and the flow of transactions through the accounting system. Our study and evaluation of the internal control systems used solely in administering these nonmajor federal financial assistance programs of the City of Example, Any State, did not extend beyond this preliminary review phase.

"Our study and evaluation was more limited than would be necessary to express an opinion on the internal control systems used in administering the federal financial assistance programs of the City of Example, Any State. Accordingly, we do not express an opinion on the internal control systems used in administering the federal financial assistance programs of the City of Example, Any State.

"Also, our examination, made in accordance with the standards mentioned above, would not necessarily disclose material weaknesses in the internal control systems, for which our study and evaluation was limited to a preliminary review of the systems, as discussed in the fifth paragraph of this report."

3. (a) All material weaknesses that have come to the auditor's attention during the audit should be described. Though only material weaknesses in internal controls need be reported, the auditor may wish to report nonmaterial weaknesses to management. This may be accomplished in the auditor's letter to management or through some similar method of communication. If a letter to management is prepared, the auditor should refer to that communication in this report.

(b) *The Standards for Audit of Governmental Organizations, Programs, Activities, and Functions*, issued by the U.S. General Accounting Office, states that well-developed findings concerning material weaknesses in internal controls generally consist of a statement of condition, the criteria, the effect, and the cause (see chapter 23 for further explanation).

It is recognized that the auditor may not be able to fully develop all of these points for each material weakness found, given the scope and purpose of the control study. The auditor should attempt to identify the condition, criteria, effect, and cause to provide sufficient information to federal, state, and local officials to permit timely and proper corrective action. These findings may also serve as a basis for a federal agency's conducting or contracting for additional audit work.

(c) Weaknesses identified relating to controls over nonmajor programs should be reported here or alternatively in a letter to management based on whether they are considered to be material or nonmaterial.

Example 21

City of Example, Any State
Schedule of Findings and Questioned Costs[1]
For the Year Ended June 30, 19XX

Program	Finding/Noncompliance	Questioned Costs[2]
Public Housing Comprehensive Improvement Assistance Program		
1. Grant No. B-78-MC-14-00009	Of twenty-five vehicles examined, one vehicle equipped with special photographic equipment was purchased and used in sewer inspections. The vehicle was used to perform repair and engineering work in the Bancroft subdivision (which is an approved project). However, it was also used on a citywide basis. Furthermore, the Department of Housing and Urban Development (HUD) approval was not obtained prior to its acquisition.	$ 28,765
2. Grant No. B-80-MC-14-0009	Of thirty-six projects examined, monies were expended on two projects, Stanley Park and Syn Way, which were not approved by HUD because appropriate environmental review procedures were not followed. The city intends to repay HUD for these costs.	49,843
		$ 78,608

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1. The summary of all noncompliance included with the schedule may provide classifications, such as major and nonmajor programs, compliance requirement categories, such as eligibility, matching, civil rights, and so on; and specific programs, for example, food stamps and special programs for aging.

2. The questioned costs represent only direct costs; applicable indirect costs should be allocated in accordance with the approved indirect cost allocation plan. Using professional judgment, the auditor may wish to include recommendations for corrective action.

Program	Finding/Noncompliance	Questioned Costs
Work Incentive Program		
1. Grant No. 18-9-0468-47	Of thirty employee files examined, wages from two participants were paid at an hourly rate in excess of that allowable by the grant.	$ 132
2. Grant No. 06-9029-XX	The city has no general indirect cost allocation plan approved under the provisions of OMB Circular A-87. However, the city had entered into a specific agreement with the Department of Health and Human Services (HHS) which provided that certain personnel costs incurred in support of work incentive programs in departments other than the city's Department of Human Resources could be charged to the grant, provided such charges were based on actual time spent in support of the program. This agreement, which was dated October 19, 19X0, expired on June 30, 19XX. In the year under audit, the city charged a total of $203,486 to grant 06-9029-XX under the terms of the agreement. Of the $203,486, $36,658 was incurred prior to July 1, 19XX. The remaining $166,828 was incurred subsequent to July 1, 19XX, after the agreement had expired. Therefore, we consider $166,828 as questioned costs.	$166,828
		$166,960

Program	Finding/Noncompliance	Questioned Costs
Urban Mass Transit Administration		
1. Grant No. 872-8190-41	This program allows contributions to a self-insurance escrow account as eligible expenses subject to certain conditions. One of these conditions is that the amounts represented as eligible expenses must reflect actual cash deposits to the account. A brief summary of the self-insurance activity follows.	$525,387

	19XX
Expense recorded	$4,255,612
Cash deposited	3,730,225
Total questioned costs	$ 525,387

Federal Financial Reports

Quarterly Financial Status Reports had not been filed on a timely basis as required by Attachment H of Circular A-102.

Quarterly financial status reports for certain grant projects were filed in excess of thirty days after the end of each quarter. Following is a summary of the reports noted to be in violation of this requirement.

Year ended December 31, 19XX

Period to Which Report Is Related	*Date of City's Cover Letter Accompanying Report*
First Quarter	November 30, 19XX
Second Quarter	February 11, 19X1
Third and Fourth Quarters	August 7, 19X1

Appendix B

Suggested Areas for Study and Evaluation of Internal Accounting Controls

The second standard of field work states: "There is to be a proper study and evaluation of existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted."

The extent of internal control that an organization should establish is a judgment that must be made by management of the entity. That judgment is affected by circumstances, such as the size of the organization and the number of personnel available, and by conclusions about the relationship of costs and benefits.

This appendix presents an inventory of areas that could be the subject of internal accounting control procedures. Though the inventory is extensive, it is not represented as being all-inclusive. Moreover, it is unlikely that procedures in all of these areas would be desirable in a single situation.

Budgets and Planning

Segregation of Duties

1. Segregation of responsibilities for budget preparation, adoption, execution, and reporting

Procedural Controls

Preparation

2. Awareness of budgets and budgetary procedures required by law
3. Preparation of budgets for all significant activities regardless of whether mandated by law
4. Preparation of budget calendar to make orderly submission and approval of the budget
5. Development and preparation of initial budget submissions by major departments and activity centers
6. Review of departmental budgets by the finance or budget officer and corrections by departments of oversights or integration of the executive's goals and objectives
7. Compatibility of the type of budgeting performed (traditional, program, performance) with the accounting system
8. Preparation of the budget in sufficient detail (responsibility level) to

provide a meaningful tool with which to monitor subsequent performance

9. Budget of interfund and interdepartmental transfers, if appropriate

Adoption

10. Budget hearings to obtain citizen input
11. Submission of the budget to the legislative body for approval; clear communication to operating departments or agencies of the effects of legislatively mandated budget modifications, either increases or decreases
12. Coincident with adoption of the budget, action of the legislative body, as appropriate, to—
    - Adopt legislation to implement the raising of budgeted revenues
    - Initiate expenditure appropriations
13. Recording in the accounting records of estimated revenues and appropriations for later comparison to actual amounts realized or incurred
14. Recording in the accounting system of budgets that have been approved by grantors in connection with grant activity
15. Publication of budgets if required by law

Execution

16. Formal adoption and communication of procedures establishing authority and responsibility for transfers between budget categories
17. Use of an allotment system to control the flow of expenditures or commitments
18. Approval as to availability of funds by the accounting department before issuance of a purchase order or expenditure commitment
19. Processing and approval of requests for supplemental appropriations or budget changes the same way as the original budget is processed and approved (or as required by law)
20. Controls to ensure knowledge of outstanding commitments if liabilities and expenditures are recorded on an encumbrance or obligation basis

Reporting

21. Comparison of actual expenditures to budget with reasonable (monthly) frequency and on a timely basis
22. Discussion of reports with departmental personnel and receiving explanations for significant variations from budget
23. Timely notification of both the executive and legislative branches of expenditures in excess of appropriations or budget
24. Publication of actual results of operations against the budget

Cash

Segregation of Duties

1. Segregation of responsibilities for collection and deposit preparation functions from those for recording cash receipts and general ledger entries
2. Segregation of responsibilities for cash receipts functions from those for cash disbursements
3. Segregation of responsibilities for disbursement preparation and disbursement approval functions from those for recording or entering cash disbursements information on the general ledger
4. Segregation of responsibilities for the disbursement approval function from those for the disbursement, voucher preparation, and purchasing functions
5. Segregation of responsibilities for entries in the cash receipt and disbursement records from those for general ledger entries
6. Segregation of responsibilities for preparing and approving bank account reconciliations from those for other cash receipt or disbursement functions
7. If EDP is used, maintenance of the principle of segregation of duties within processing activities

Procedural Controls

Collections

8. Timely deposit (preferably daily) of all receipts
9. Controls over the collection, timely deposit, and recording of collections in the accounting records in each collection location
10. Timely notice of cash receipts from separate collection locations to general accounting department
11. Comparison of daily reported receipts on a test basis to bank statements to verify timeliness of deposits
12. Placing a restrictive endorsement on incoming checks as soon as received
13. Delivery of "not sufficient funds" checks to someone independent of processing and recording of cash receipts
14. Procedures for follow-up of "not sufficient funds" checks
15. Controls to ensure that checks are returned promptly for deposit if checks received are forwarded to be used as posting media to taxpayers' or customers' accounts
16. Receipts controlled by cash register, prenumbered receipts, or other equivalent means if payments are made in person (over the counter)
17. Accounting for such receipts and balancing them to collections daily

18. Facilities for protecting undeposited cash receipts

Disbursements

19. Control over warrant or check-signing machines as to signature plates and usage
20. Procedures providing for immediate notification to banks when warrant or check signers leave the unit or are otherwise no longer authorized to sign
21. Furnishing invoices and supporting documents to the signer prior to signing the warrant or check
22. Setting reasonable limits on amounts that can be paid by facsimile signatures
23. Requiring two signatures on warrants or checks over a stated amount
24. Maintaining signature plates in the custody of the person whose facsimile signature is on the plate when not in use
25. Using plates only under the signer's control and recording machine reading by the signer or an appropriate designee to ascertain that all checks or warrants signed are properly accounted for by comparison to document control totals
26. Direct delivery to the mail room of signed warrants or checks, making them inaccessible to persons who requested, prepared, or recorded them
27. Prohibiting the drawing of warrants or checks to cash or bearer

Custody

28. Maintenance of controls over the supply of unused and voided warrants or checks
29. Proper authorization of bank accounts
30. Periodically reviewing and formally reauthorizing depositories
31. Controls and physical safeguards surrounding working (petty cash) funds
32. Maintenance of adequate fidelity insurance
33. Maintenance of separate bank accounts for each fund, or if not, adequate fund control over pooled cash

Detail Accounting

34. Procedures ensuring that collections and disbursements are recorded accurately and promptly
35. Procedures for authorizing and recording interbank and interfund transfers providing for proper accounting for those transactions

General Ledger

36. General ledger control over all bank accounts
37. Delivery of bank statements and paid warrants or checks in unopened envelopes directly to the employee preparing the reconciliation
38. Procedures for steps essential to an effective reconciliation, particularly—
    - Comparison of warrants or checks in appropriate detail with disbursement records
    - Examination of signature and endorsements, at least on a test basis
    - Accounting for numerical sequence of warrants or checks used
    - Comparison of book balances used in reconciliations with general ledger accounts
    - Comparison of deposit amounts and dates with cash receipt entries
    - Footing of cash books
39. Review and approval of all reconciliations and investigation of unusual reconciling items by an official who is not responsible for receipts and disbursements, including recording evidence of the review and approval by signing the reconciliation
40. Periodic investigation of checks outstanding for a considerable time

Investments

Segregation of Duties

1. Segregation of responsibilities for initiating, evaluating, and approving transactions from those for detail accounting, general ledger, and other related functions
2. Segregation of responsibilities for initiating transactions from those for final approvals that commit government resources
3. Segregation of responsibilities for monitoring investment market values and performance from those for investment acquisition
4. Segregation of responsibilities for maintaining detail accounting records from those for general ledger entries
5. Assignment of custodial responsibilities for securities or other documents evidencing ownership or other rights to an official who has no accounting duties
6. If EDP is used, maintaining the principle of segregation of duties within processing activities

Procedural Controls

Approval

7. If applicable, procedures adequate to ensure that only investments that are permitted by law are acquired

8. Formal establishment and periodic review of investment policy guidelines
9. Integration of the investment program with cash management program and expenditure requirements
10. Established authority and responsibility for investment opportunity evaluation and purchase
11. Periodic evaluation of the performance of the investment portfolio by persons independent of investment portfolio management activities
12. Formal establishment of procedures governing the level and nature of approvals required to purchase or sell an investment
13. Use of competitive bidding for certificate of deposit purchases

Custody

14. Adequate physical safeguards and custodial procedures over—
    - Negotiable and nonnegotiable securities owned
    - Legal documents or agreements evidencing ownership or other rights
15. Dual signatures or authorizations to obtain release of securities from safekeeping or to obtain access to the government unit's safe deposit box
16. Authorization by the legislative body of persons with access to securities
17. Registering all securities in the name of the government unit
18. Periodic inspection or confirmation of securities from safekeeping agents
19. Bonding of individuals with access to securities

Detail Accounting

20. Maintenance of detail accounting records for investments
21. Procedures to ensure that transactions arising from investments are properly processed, including income and amortization entries
22. Controls to ensure that investment earnings are credited to the fund from which resources were provided for the investment
23. A periodic comparison between income received and the amount specified by the terms of the security or publicly available investment information
24. Controls to ensure that transactions are recorded on a timely basis

General Ledger

25. Procedures for reconciling the detail accounting records with the general ledger control
26. Periodic review of the nature of investments included in general ledger balances

Revenues and Receivables

Segregation of Duties

1. Segregation of the responsibilities for billing property taxes and services from collection and accounting
2. Segregation of the responsibilities for maintaining detail accounts receivable records from collections and general ledger posting
3. Segregation of collection, control, and deposit of funds activities from maintaining accounting records
4. Maintenance of the property tax assessment rolls by individuals not engaged in any accounting or collection function
5. Segregation of the responsibilities for entries in the cash receipts records from those for general ledger entries
6. If EDP is used, maintenance of the principle of segregation of duties within processing activities

Procedural Controls

Data and File Maintenance

Property taxes

7. Controls to ensure that additions, deletions, transfers, and abatements are properly and timely reflected in property tax records
8. Procedures to make property assessments in accordance with the law or legislative intent with prompt adjustment of records

Sales, income, and other taxes

9. Cross-referencing returns filed against a data base of previous taxpayers
10. Organization and integration of the records in such a fashion that probable taxpayers are identified as a result of reporting of other governmental activities such as licensing

License fees and permits

11. If annual payments are involved, procedures to ensure that previous years' records are properly updated for new registrants and withdrawals
12. Use of the updated records as the basis for billing persons subject to payment

Fines, forfeitures, and court fees

13. Maintaining and using court and other records of payments due as a basis for collections
14. Procedures surrounding the control, issuance, and disposition of traffic violations to ensure that amounts due are assessed and collected

Enterprise and other service revenues

15. Maintaining controls that provide assurances that customer data base and, where appropriate, usage records are accurately maintained to ensure that amounts due are billed

Billing/Remittance Verification

Property taxes

16. Controls within the billing system to ensure that eligible property owners are billed
17. Controls to ensure that tax assessments are being properly applied against tax rates and special charges are being considered in the preparation of billing amounts
18. Controls to ensure that tax exemptions are within the law and properly approved

Sales, income and other taxes

19. Reviewing returns for mathematical accuracy
20. Correlation of current year's taxpayers' returns with prior year's returns and accounting for and reviewing differences
21. Separate review and approval of claims for refunds
22. Audits of returns filed to provide reasonable assurance that taxable income is properly reported

License fees and permits

23. Comparison of current year receipts to those for prior years and review of explanations of variations by senior officials

Fines, forfeitures, and court fees

24. Procedures providing for correlation of amounts collected with records of court proceedings

25. Sequentially numbering and satisfactorily accounting for tickets for fines, arrests, and so forth

Enterprise and other service revenues

26. If billing is based on usage, performing service readings in a timely fashion
27. Periodic rotation of the assignments of meter readers
28. Billing procedures providing for identification and investigation of unusual patterns of use

General

29. Billing of taxes and fees in a timely fashion
30. Procedures designed for other revenue areas ensuring timely payment of amounts due
31. Periodic review and approval by the legislative body of the rates of taxes, fines, fees, and services
32. Periodic review and approval by the legislative body of programs of tax exemption or relief
33. Authorization by the legislative body of utility rate schedules
34. Procedures providing for timely notification of the accounting department at the time tax, service, or other billings or claims are prepared and rendered
35. Numerical or batch-processing controls over tax, fee, service, or other billings
36. Controls over the billing of miscellaneous revenues (for example, sidewalk replacement and tree removal assessments)
37. Procedures to prevent the interception or alteration by unauthorized persons of billings or statements after preparation but before they are mailed
38. Prompt investigation of disputes with billing amounts that are reported by taxpayers or service recipients by an individual independent of receivables record keeping
39. Controls providing reasonable assurances that restricted revenues are expended only for restricted purposes

Collection

40. Placing a restrictive endorsement on incoming checks as soon as received
41. Procedures providing reasonable assurances that interest and penalties are properly charged on delinquent taxes, fees, or charges for service

42. Procedures providing for the timely filing of liens on property for nonpayment in all cases permitted by law
43. Controls surrounding the collection, timely deposit, and recording of collections in the accounting records at each collection location
44. Timely notice of cash receipts from separate collection centers to general accounting department
45. If payments are made in person, use of receipts for payment and accounting for and balancing of such receipts to collections
46. Segregation and timely remittance of amounts collected on behalf of other governments
47. Monitoring taxes and fees collected by another unit of government to assure timely receipt and subjecting amounts received to reviews for reasonableness
48. Reviewing delinquent accounts and considering them for charge-off on a timely basis
49. Formally approved write-offs or other reductions of receivables by senior officials not involved in the collection function
50. Procedures providing for execution of all legal remedies to collect charged-off or uncollectible accounts, including tax sale of property, liens, and so forth

Accounts Receivable Record Keeping

51. Controls in the system that provide assurances that individual receivable records are posted only from authorized source documents
52. Reconciling the aggregate collections on accounts receivable against postings to individual receivable accounts
53. Where appropriate (for example, in proprietary funds), mailing statements of account balance on a timely basis

General Ledger

54. Regular preparation of trial balances of individual receivable accounts
55. Reconciliation of trial balances with general ledger control accounts and investigation of reconciling items by other than accounts receivable clerks
56. Periodic review of aged accounts receivable balances by supervisory personnel
57. Procedures providing for timely and direct notification of the accounting department of billings and collection activity

Grant and Entitlement Monitoring

Grants

58. Properly fixed responsibility for monitoring grant activities

59. A central grants monitoring activity
60. Procedures to monitor compliance with—
    - Financial reporting requirements
    - Use of funds and other conditions in accordance with grant terms
    - Timely billing of amounts due under grants
61. Accounting for grant activity so that it can be separated from the accounting for locally funded activities
62. System for obtaining grantor approval before incurring expenditures in excess of budgeted amounts or for unbudgeted expenditures
63. Processing grant revenues and disbursements under the same degree of controls applicable to the organization's other transactions (budget, procurement, etc.)
64. Including requirements in subgrantee agreements that the subgrantee comply with primary grant agreement conditions as well as grantee's standards
65. Reasonable procedures and controls to provide assurances of compliance with recipient eligibility requirements established by grants
66. Establishing an indirect cost allocation plan
67. Approval of the plan by all grantor agencies
68. Establishing audit cognizance for rates generated by the plan

Entitlements

69. Comparison of the amount of funds received with the amount anticipated by a responsible official and investigation of unusual variances
70. Procedures to ensure that funds received are spent in accordance with legal requirements and spending restrictions
71. Review of any statistical or data reports that form the basis for revenue distribution by a responsible official before submission

Capital Assets

Segregation of Duties

1. Segregation of responsibilities for initiating, evaluating, and approving capital expenditures, leases, and maintenance or repair projects from those for project accounting, property records, and general ledger functions
2. Segregation of responsibilities for initiating capital asset transactions from those for final approvals that commit government resources
3. Segregation of responsibilities for the project accounting and property records functions from the general ledger function
4. Segregation of responsibilities for the project accounting and property records functions from the custodial function
5. Assigning the responsibilities for the periodic physical inventories of

capital assets to responsible officials who have no custodial or record-keeping responsibilities
6. If EDP is used, maintaining the principle of segregation of duties within processing activities

Procedural Controls

Authorization

7. Identification of those individuals authorized to initiate capital asset transactions and clear definition of the limits of their authority
8. Establishing guidelines with respect to key considerations such as prices to be paid, acceptable vendors and terms, asset quality standards, and the provisions of grants or bonds that may finance the expenditures
9. Preparation of a separate capital projects budget

Executive or Legislative Approval

10. Requiring written executive or legislative approval for all significant capital asset projects or acquisitions
11. Procedures for authorizing, approving, and documenting sales or other dispositions of capital assets
12. Procedures for approving decisions regarding financing alternatives and accounting principles, practices, and methods
13. Procedures providing for obtaining grantor (federal/state) approval, if required, for the use of grant funds for capital asset acquisitions
14. Subjecting grant-funded acquisitions to the same controls as internally funded acquisitions
15. Requiring supplemental authorizations, including, if appropriate, those of the grantor agency, for expenditures in excess of originally approved amounts

Project Accounting

16. Engaging a qualified employee or independent firm to inspect and monitor technically complex projects
17. Establishing and maintaining project cost records for capital expenditure and repair projects
18. Reporting procedures for in-progress and completed projects
19. Procedures to identify completed projects so that timely transfers to the appropriate accounts can be made
20. Review of the accounting distribution to ensure proper allocation of charges to fixed asset and expenditure projects

21. If construction work is performed by contractors, procedures to provide for and maintain control over construction projects and progress billings
22. The unit of government having the right to audit contractors' records
23. Exercising the right to audit contractor records during project performance
24. Audits of contractor compliance with EEO, Davis Bacon, and other regulations and contract terms, in addition to costs

Asset Accountability

25. Maintaining detail property records for all significant self-constructed, donated, purchased, or leased assets
26. Establishing the accountability for each asset
27. Procedures for periodic inventory of documents evidencing property rights (for example, deeds, leases, and the like)
28. Physical safeguards over assets
29. Procedures ensuring that purchased materials and services for capital expenditure and repair projects are subjected to the same levels of controls as exist for all other procurements (for example, receiving, approval, checking)
30. Periodically comparing detail property records with existing assets
31. Investigating differences between records and physical counts and adjusting the records to reflect shortages
32. Procedures ensuring that capital assets are adequately insured
33. Subjecting lease transactions to control procedures similar to those required for other capital expenditures
34. Properly identifying equipment by metal numbered tags or other means of positive identification
35. Carrying fully depreciated assets in the accounting records as a means of providing accounting control
36. Procedures for monitoring the appropriate disposition of property acquired with grant funds

General Ledger

37. Periodic reconciliation of the detail property records with the general ledger control accounts
38. Procedures and policies to—
    - Distinguish between capital projects fund expenditures and operating budget expenditures
    - Identify operating budget expenditures to be capitalized in fixed asset fund

- Distinguish between capital and operating leases
- Govern depreciation methods and practices

39. If costs are expected to be charged against federal grants, depreciation policies or methods of computing allowances in accord with the standards outlined in OMB circulars or grantor agency regulations; if not, adjusting depreciation charged to grants accordingly
40. The accounting records should be adjusted promptly—both the asset and related allowance for depreciation—when items of plant and equipment are retired, sold, or transferred

Procurement and Payables

Segregation of Duties

1. Segregation of responsibilities for the requisitioning, purchasing, and receiving functions from the invoice processing, accounts payable, and general ledger functions
2. Segregation of responsibilities for the purchasing function from the requisitioning and receiving functions
3. Segregation of responsibilities for the invoice processing and accounts payable functions from the general ledger functions
4. Segregation of responsibilities for the disbursement preparation and disbursement approval functions from those for recording cash disbursements and general ledger entries
5. Segregation of responsibilities for the disbursement approval function from those for the disbursement preparation function
6. Segregation of responsibilities for entries in the cash disbursement records from those for general ledger entries
7. If EDP is used, maintaining the principle of segregation of duties within processing activities

Procedural Controls

Requisitioning

8. Initiation of purchases of goods and services by properly authorized requisitions bearing the approval of officials designated to authorize requisitions
9. Using and accounting for prenumbered requisitions
10. Indicating the appropriation to be charged on the purchase requisition by the person requesting the purchase
11. Before commitment, verification by the accounting or budget department that there are sufficient unobligated funds remaining under the appropriation to meet the proposed expenditure
12. Having technical specifications accompanying requests for special purpose (nonshelf items) materials or personal services

13. Structuring purchasing authorizations to give appropriate recognition to the nature and size of purchases and the experience of purchasing personnel
14. Purchase order and contract issuance and approval procedures
15. Periodic review of purchase prices by a responsible employee independent of the purchasing department
16. Use of competitive bidding procedures
17. If practicable, rotation on a regular basis of contract or purchasing officer's areas of responsibility
18. Provisions in contracts for materials, services, or facilities acquired on other than a fixed price basis that provide for an audit of contractors' costs, with payments subject to audit results
19. Procedures for public advertisement of nonshelf item procurements in accordance with legal requirements
20. Periodic review of recurring purchases and documentation of the justification for informal rather than competitive bids
21. Establishing, documenting, and distributing policies regarding conflicts of interest and business practice policies
22. Issuing purchase orders and contracts under numerical or some other suitable control
23. Obtaining an adequate number of price quotations before placing orders not subject to competitive bidding
24. Prohibiting splitting orders to avoid higher levels of approval
25. Maintenance of price lists and other appropriate records of price quotations by the purchasing department
26. Maintenance of a record of suppliers who have not met quality or other performance standards by the purchasing department
27. Modification of procedures when funds disbursed under grant or loan agreements and related regulations impose requirements that differ from the organization's normal policies
28. Institution of procedures to identify, before order entry, costs and expenditures not allowable under grant (federal/state) programs
29. Maintenance of an adequate record of open purchase orders and agreements
30. Prohibiting or adequately controlling purchases made for the accommodation of employees
31. Considering bid and performance bonds if construction contracts are to be awarded
32. Predetermining selection criteria for awarding personal service or construction contracts and requiring adequate documentation of the award process
33. Subjecting changes to contracts or purchase orders to the same controls and approvals as the original agreement

Receiving

34. Preparation of receiving reports for all purchased goods
35. Procedures for the filing of claims against carriers or vendors for shortages or damaged materials
36. Taking steps to ensure that goods received are accurately counted and examined to see that they meet quality standards
37. Maintaining a permanent record of material received by the receiving department
38. Numerically accounting for or otherwise controlling receiving reports to ensure that all receipts are reported to the accounting department
39. Sending copies of receiving reports directly to purchasing, accounting, and, if appropriate, inventory record keeping
40. With respect to procurements of special purpose materials, services, or facilities, assigning a government technical representative to monitor and evaluate contractor performance and approve receipt of services
41. If a receiving department is not used, adequate procedures to ensure that goods for which payment is made have been received; verification by someone other than the individual approving payment that goods have been received and meet quality standards

Invoice Processing

42. Invoice processing procedures providing for—
    - Obtainment directly from issuing departments of copies of purchase orders and receiving reports
    - Comparison of invoice quantities, prices, and terms with those indicated on purchase order
    - Comparison of invoice quantities with those indicated on receiving reports
    - As appropriate, checking accuracy of calculations
43. Receiving all invoices from vendors in a central location, such as the accounting department
44. Procedures ensuring that the accounts payable system is properly accounting for unmatched receiving reports and invoices
45. Relating requests for progress payments under long-term contracts to contractors' efforts and formally approving them
46. Procedures for processing invoices not involving materials or supplies (for example, lease or rental payments, utility bills)
47. Procedures ensuring accurate account distribution of all entries resulting from invoice processing
48. If applicable, limiting access to EDP master vendor file to employees authorized to make changes
49. Maintenance by the accounting department of a current list of those authorized to approve expenditures

50. Procedures for submission and approval of reimbursement to employees for travel and other expenses
51. Establishment of control by the accounting department over invoices received before releasing them for departmental approval and other processing
52. Review of the distribution of charges in the accounting department by a person competent to pass on the propriety of the distribution
53. Review and approval of invoices (vouchers) for completeness of supporting documents and required clerical checking by a senior employee
54. If an invoice is received from a supplier not previously dealt with, taking steps to ascertain that the supplier actually exists
55. Making payments only on the basis of original invoices
56. Fixing responsibility for seeing that all cash discounts are taken and, if applicable, that exemptions from sales, federal excise, and other taxes are claimed
57. Referring differences in invoice and purchase order price, terms, shipping arrangements, or quantities to purchasing for review and approval
58. Recording and following up partial deliveries by the accounting department
59. Promptly notifying the accounting and purchasing departments of returned purchases, and correlating such purchases with vendor credit advices
60. Reviewing the program and expenditure account to be charged for propriety and budget conformity
61. Having check signers or other responsible officials determine that restricted revenues are expended only for restricted purposes
62. If applicable, procedures to ensure adjustment of the reserve for encumbrances (obligations) when invoices are prepared for payment

Disbursements

63. Disbursement approval and warrant or check-signing procedures
64. Control over warrant or check-signing machines as to signature plates and usage
65. Procedures to notify banks when a new signer is authorized or a previous signer leaves the employ of the government
66. Furnishing and having the signer review invoices and supporting data before signing the warrant or check
67. Setting reasonable limits on amounts that can be paid by facsimile signatures
68. Requiring two signatures on all warrants or checks over a stated amount
69. Maintaining signature plates in the custody of the person whose facsimile signature is on the plate when not in use

70. Using plates only under the signer's control and having that person or an appropriate designee record machine readings to ascertain that all checks or warrants signed are properly accounted for
71. Cancellation of invoices and supporting documents by or in the presence of the signer at time of signing
72. Delivery of signed warrants or checks directly to the mail room, making them inaccessible to persons who requested, prepared, or recorded them
73. Cross-referencing warrants or checks to vouchers
74. Control of and accounting for warrants or checks with safeguards over those unused and voided
75. Prohibiting the drawing of warrants or checks to cash or bearer
76. Procedures ensuring that warrants or checks that have been signed and issued are recorded promptly

Accounts Payable Encumbrances or Obligations

77. Regular comparison of statements from vendors with recorded amounts payable
78. If an encumbrance (obligation) system is used, monthly reconciliation of outstanding purchase orders to the reserve for encumbrances (obligations)
79. Recording encumbrance (obligation) entries based only on approved purchase orders
80. Procedures ensuring that accounts payable and encumbrances (obligations) are applied against the appropriate account
81. Procedures ensuring that department heads are notified of payments made against accounts payable and encumbrances (obligations)

General Ledger

82. Regular preparation of trial balances of reserve for encumbrances (obligations) and accounts payable
83. Checking the footing and testing the trial balances to the individual items as well as comparing the total to the general ledger balance by an employee other than the accounts payable clerk
84. Posting transactions between funds in all affected funds in the same accounting period and on a timely basis

Grant and Entitlement Monitoring

85. Disbursing grants only on the basis of approved applications
86. Defining (for example, in regulations) and communicating to grantees their reporting and compliance requirements
87. Procedures to monitor grantee compliance with grant terms
88. Subjecting financial operations of grantees to periodic and timely audit

89. Sufficiently timely monitoring of recipients to permit curtailment of any abuse before complete funds disbursement
90. Disbursing funds to grantees only on an as-needed basis
91. A level of grant approval authority that appears appropriate
92. Investigation of failure by grantees to meet financial reporting requirements on a timely basis
93. Requiring grantees to evidence correction of previously detected deficiencies before approval of an extension or renewal of a grant
94. Entitlement procedures ensuring that statistics or data used to allocate funds are accurately accumulated (for example, census bureau forms)
95. Requiring statements of recipient compliance with entitlement conditions (for example, statement of assurances) to be filed and having a responsible official review them
96. Review of audited financial statements or other compliance requirements of entitlement recipients on a timely basis and investigation of unusual items

Employee Compensation

Segregation of Duties

1. Segregation of responsibilities for supervision and time-keeping functions from personnel, payroll processing, disbursement, and general ledger functions
2. Segregation of responsibilities for the payroll processing function from the general ledger function
3. Supervision of payroll distribution by employees—
   - Who are not responsible for hiring or firing employees
   - Who do not approve time reports
   - Who take no part in payroll preparation
4. Segregation of responsibilities for initiating payments under employee benefit plans from accounting and general ledger functions
5. Reconciliation of the payroll bank account regularly by employees independent of all other payroll transaction processing activities
6. If EDP is used, maintaining the principle of segregation of duties in processing activities

Procedural Controls

Personnel

7. Properly authorizing, approving, and documenting all changes in employment (additions and terminations), salary and wage rates, and payroll deductions

8. Promptly reporting notices of additions, separations, and changes in salaries, wages, and deductions to the payroll-processing function
9. Maintaining appropriate payroll records for accumulated employee benefits (vacation, pension data, etc.)
10. Interviewing terminating employees as a check on departure and as a final review of any termination settlement by the personnel department
11. Written personnel policies
12. Establishing controls to ensure that payroll costs charged to grants are in compliance with grant agreements
13. Payroll and personnel policies governing compensation that are in accordance with the requirements of grant agreements
14. Determining that wages are at or above the federal minimum wage

Supervision/Timekeeping

15. Review and approval of hours worked, overtime hours, and other special benefits by the employee's supervisor
16. Timekeeping and attendance records and procedures
17. Review for completeness and approval of time cards or other time reports by the employee's supervisor
18. Punching of time cards, if used, only by the employees to whom they are issued
19. Placing the time clock in a position where it can be observed by a supervisor
20. Procedures for authorizing, approving, and recording vacations, holidays, and sick leave and approving and controlling compensatory time

Payroll Processing

21. Controls over payroll preparation
22. Approval and documentation of changes to the EDP master payroll file
23. Limiting access to the EDP master payroll file to employees who are authorized to make changes
24. Review and approval of completed payroll registers before disbursements are made
25. Review of documents supporting employee benefit payments (such as accumulated vacation or sick leave) before disbursements are made
26. Review for reasonableness of comparisons (reconciliations) of gross pay of current to prior period payrolls by a knowledgeable person not otherwise involved in payroll processing
27. Review of the payroll (examination of authorizations for changes noted on reconciliations) by an employee not involved in its preparation
28. Balancing the distribution of dollars and hours of gross pay with payroll

registers, and review by someone independent but knowledgeable of this area

29. Including in the review a comparison to amounts appropriated and budgeted
30. Prohibiting payroll advances to officials and employees or subjecting them to appropriate review

Disbursement

31. Keeping the signature plates and use of the payroll check-signing machines under control of the official whose name appears on the signature plate or an employee to whom he has delegated that responsibility
32. Maintaining a log that reconciles the counter on the check-signing machine with the number of checks issued in each payroll
33. Maintaining a separate, imprest-basis, payroll bank account
34. Regularly reconciling the payroll bank account
35. Comparing payroll check endorsements, on a test basis, with signatures on file by someone independent of the payroll department
36. If payment is made in cash, requiring signed receipts; having someone independent of the payroll department compare them, on a test basis, with signatures on file
37. Controlling the supply of unused payroll checks
38. Requiring employees to provide identification before being given checks or pay envelopes
39. Prohibiting employees from accepting another employee's pay
40. Returning unclaimed wages to a custodian independent of the payroll department
41. Having employees who distributed checks or pay envelopes make a report of unclaimed wages directly to the accounting department
42. Making payments of unclaimed wages at a later date only upon presentation of appropriate evidence of employment and approval by an officer or employee who is not responsible for payroll preparation or time reporting
43. Comparing W-2 forms to payroll records and mailing by employees not otherwise involved in the payroll process
44. Procedures for investigating returned W-2s
45. Periodic distribution of payroll checks by the internal auditors to ascertain that employees exist for all checks prepared

General Ledger

46. Adequate account coding procedures for classification of employee compensation and benefit costs so that such costs are recorded in the proper general ledger account

47. Proper recording or disclosure of accrued liabilities for unpaid employee compensation and benefit costs

Electronic Data Processing

Segregation of Duties

1. Independence of the EDP department from the accounting and operating departments for which it processes data
2. Appropriate segregation of duties within the data processing function for (a) systems development (design and programming), (b) technical support (maintenance of systems software), and (c) operations
3. In smaller and minicomputer installations with limited opportunities for segregation of duties, procedures for user departments to—
   - Utilize batch or other input controls
   - Control master file changes
   - Balance master files between processing cycles
4. Having the personnel policies of the EDP function include such procedures as reference checks, security statements, rotation of duties, and terminated employee security measures that enhance segregation of duties and otherwise improve controls

Procedural Controls

User Controls

5. Controls over preparation and approval of input transactions outside the EDP department and prohibiting the department from initiating transactions
6. Having the user exercise control procedures over input to ensure that all approved input is processed correctly through the system and only once
7. Having controls over entry of data in on-line systems to restrict access to terminals and data entry to authorized employees
8. On-line systems controls that prevent documents from being keyed into the system more than once and that permit tracing from computer output to data source and vice versa
9. Controls over changes to master files, such as requiring preparation of specific forms indicating data to be changed, approval by a supervisor in the user department, and verifying against a printout of changes
10. User controls over rejected transactions through the use of a computerized suspense file of rejected transactions or an auxiliary manual system
11. User department management reconciliation of output totals to input totals for all data submitted, reconciliation of the overall file balances, and review of outputs for reasonableness

Application Controls

12. Procedures within the data processing control function that provide that data is properly controlled between the user and EDP department
13. Controls over data entry, for example, that include adequate supervision, up-to-date instructions, key verification of important fields, and self-checking digits
14. Program controls over entry of data into on-line systems
15. Editing and validation of input data
16. Data processing controls over rejected transactions
17. Controls for balancing transaction and master files
18. Procedures within the data processing control function concerning review and distribution of output

General Controls

19. Controls over changes to system software
20. Controls over use and retention of tape and disk files, including provisions for retention of adequate records to provide backup capabilities
21. Controls that limit access to data processing equipment, tapes, disks, system documentation, and application program documentation to authorized employees
22. Use of a job accounting system (or console logs) to ensure that scheduled programs are processed and proper procedures followed and that supervisory personnel know that only required programs have been processed
23. Supervision of EDP department employees for all shifts
24. Documentation of procedures to be followed by computer operators
25. Documentation of the data processing system such that the organization could continue to operate if important data processing employees leave
26. Procedures to protect against a loss of important files, programs, or equipment
27. Insurance to cover equipment, programs, and data files
28. User-approved written specifications for new systems and modifications to existing application systems
29. Procedures to test and implement new systems and modifications to existing application systems

Financial Reporting

Segregation of Duties

1. Segregation of the final review and approval of financial reports from the responsibility for preparation of the reports

2. Segregation of the responsibilities for maintaining the general ledger from those for maintaining subsidiary ledgers
3. Segregation of the responsibilities for maintaining the general ledger and custody of assets
4. Segregation of the preparation and approval functions for journal entries
5. Segregation of principal accounting, treasury, and custody functions
6. If EDP is used, maintaining the principle of segregation of duties within processing activities

Procedural Controls

General Ledger

7. A formal plan of organization for the unit of government under which reporting responsibilities are clearly defined and reasonably aligned
8. Supervision of a principal accounting officer over accounting records and accounting employees at all locations
9. General ledger control over all assets and transactions of all departments of the organization
10. Bonding employees in positions of trust in amounts required by statutes or organization policy
11. Written accounting, policy, and procedural manuals that are distributed to appropriate personnel
12. Updating the accounting, policy, and procedural manuals as necessary
13. Procedures to ensure that only authorized persons can alter or establish a new accounting principle, policy, or procedure to be used by the organization
14. Security for accounting records
15. A formal policy regarding conflicts of interest
16. Requiring written representations from appropriate personnel as to compliance with accounting policies and procedures and ethics policies
17. Prohibiting or closely controlling loans to officials or employees
18. Periodically evaluating the adequacy and effectiveness of the internal accounting controls related to the organization's transaction systems (procurement, revenues and receivables, etc.)
19. Implementing measures to correct weaknesses

Closing

20. Procedures and policies for closing the accounts for a reporting period sufficient to ensure that accounts are closed, adjusted, and reviewed on a timely basis
21. Procedures to ensure that all accounting systems have included all transactions applicable to the reporting period

22. Review and approval of valuation reserves or other account balances based on estimates
23. Having all journal entries reviewed, approved, and supported by adequate descriptions or documentation
24. Controls that ensure that only authorized individuals can initiate entries

Combining

25. Procedures to ensure the orderly and effective accumulation of financial data
26. Procedures for the orderly processing of financial data received from departments and other accounting units
27. Procedures to permit the recording and review of special entries generated in the combining process

Preparation, Review, and Approval

28. Procedures to ensure that financial reports are supported by either underlying account records or other documentation
29. Procedures providing reasonable assurances that all data required to be included in legal as well as public reports are properly disclosed
30. Procedures to ensure that financial reports are prepared on a consistent basis
31. Review and approval of financial reports at appropriate levels of management and, if appropriate, the legislature before public release
32. Procedures to ensure that all requirements for filing of financial reports are met (for example, senior levels of government, bondholders, and public.)

Appendix C

OMB Circulars That Address Management of Federal Assistance Programs Applicable to State and Local Governments

(This appendix presents only a synopsis of certain OMB circulars.)

C.1 The U.S. Office of Management and Budget (OMB), in consultation with federal grantor agencies, the General Accounting Office (GAO), and representatives of recipient governments, has developed a series of financial circulars that provide guidance to be observed by all federal executive branch agencies in imposing financial and other administrative requirements on recipients of federal assistance. Two of these circulars, A-87 and A-102, which are applicable to state and local governments, are summarized below.

OMB Circular A-87 Cost Principles Applicable to Grants and Contracts

What Is Circular A-87?

C.2 Circular A-87 provides uniform rules for determining costs applicable to grants and contracts with state and local governments. It defines allowable costs and sets forth the procedures to recover them. The basic intent underlying the circular is that federally assisted programs should bear their fair share of costs. The circular also provides that one federal agency will negotiate grantees' indirect costs on behalf of all other federal agencies.[1]

Allowable Costs

C.3 Generally, costs must be necessary, reasonable, and directly related to the grant. In addition, they must be legal, proper, and consistent with the policies that govern the recipient's own expenditures. Any credits, such as purchase discounts, price adjustments, and federal funds available from other sources, must be deducted from total costs.

Composition of Cost

C.4 Costs applicable to a grant program may be direct or indirect. There are no strict guidelines for classifying costs as direct or indirect. In most

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1. Generally referred to as federal cognizant agency for indirect costs.

cases, the accounting system used by the recipient will specify which types of costs are direct and which are indirect. The important point is that recipients treat costs consistently for all grant programs.

C.5 Direct costs should be specifically identifiable to the grant. Typical examples are employee compensation, materials, equipment, and services furnished specifically for the grant by others.

C.6 Indirect costs are those incurred for common or joint purposes that benefit more than one activity. These costs should be allocated so that each activity bears its fair share of total indirect costs. To do this, a recipient should develop an indirect cost allocation plan. The plan, which incorporates a methodology for determining allowable indirect costs, results in the determination of an indirect cost rate. This rate is applied to a direct cost base to determine the amount of indirect costs allowable to an activity. When indirect cost rates cannot be readily determined, recipients may negotiate a fixed amount to be used as a substitute. In some cases, indirect costs are limited by legislation.[2] Any excess indirect cost caused by such limitations may not be shifted to other grants.

Cost Allocation Plan

C.7 In order to recover indirect costs, the recipient must develop a cost allocation plan that provides the basis for the indirect cost rate. To be acceptable, the plan must consider all indirect costs of the department administering the grant and other agencies' costs that will be charged against the grant.[3] The plan should (a) describe the services provided and explain their relevance to the grant programs, (b) list the expenses to be charged to the grants, and (c) explain the method used to distribute costs.

C.8 The Department of Health and Human Services with OMB approval has issued instructions to state and local governments for the preparation of cost allocation plans. State agencies and departments must have their plans approved before indirect costs can be recovered. Local governments and departments need not submit plans for approval unless requested to by the agency responsible for reviewing their plans. However, they must retain their plans, in case of a subsequent audit.

Cognizant Agency List

C.9 All federal programs incur direct and indirect costs as part of their ongoing operations. In order to spread the administrative load of plan review and approval, the OMB publishes a list of cognizant agencies and the organizations whose plans they are responsible for reviewing.

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2. The auditor should be aware that federal grants may be subject to laws that limit the amount of indirect costs that may be allowed. Agencies that sponsor grants of this type will establish procedures which will assure that the amount actually allowed for indirect costs under each such grant does not exceed the maximum allowable under the statutory limitation or the amount otherwise allowable under the Circular, whichever is the smaller.

3. For states and larger cities, there are usually two allocation plans, one for centralized services and one at the department or agency level.

OMB Circular A-102
Uniform Administrative Requirements
for Grants-in-Aid to State and Local Governments

What is Circular A-102?

C.10 Circular A-102 establishes uniform financial and other administrative requirements for grants to state and local governments. It promotes uniformity and consistency among federal agencies in their administration of grants. It establishes uniform requirements in sixteen areas. Only those specific requirements imposed by legislation establishing a grant program can take precedence over A-102.

The following is a summary of specific attachments of the circular.

Attachment

A. *Cash depositories.* State and local governments can use their regular banking procedures, without any requirements for separate bank accounts, or special bank eligibility procedures. Use of minority banks is encouraged.

B. *Bonding and insurance.* Except as otherwise required by law, recipients can use normal bonding and insurance procedures for contracts of $100,000 or less. If the agency is certain that the government's interests are adequately protected, the recipient's procedures may be used for contracts larger than $100,000. If that is not the case, construction contracts over $100,000 must have a 5-percent bid guarantee, a 100-percent performance bond, and a 100-percent payment bond. No other federal requirements in this area should be imposed.

C. *Records retention.* Recipients may follow their own practices as long as they retain records for three years, in order to allow access for audit and public examination. If audit findings are not resolved, the records shall be retained beyond three years. The retention period starts when the annual or final expenditure report has been submitted or, for non-expendable property, from the date of final disposition.

D. *Waiver of single state agency requirements.* When requested by a state, federal agencies should waive or remove single state agency requirements. Such requirements set up impediments to effective administration. Future legislation should avoid single state agency requirements if possible.

E. *Program income.* Program income means gross income earned by the recipient entity from grant-supported activities. Interest earned on advances of federal funds shall be remitted to the federal agency except for interest earned on advances to states and instrumentalities of a state. Other income attributable to the grant should be used to increase the scope of the project. Program income must be deducted from the total project cost to determine the amount in which the federal government will share, or it must be applied toward the matching share (with federal agency permission).[4]

F. *Matching share*. Standards are established for determining the matching contribution. It can consist of charges that are project costs, including cash and "in-kind" contributions. In-kind contributions must be necessary and reasonable, identifiable from the grantee's records, properly valued, and not claimed for any other federal program. Specific guidelines are set forth calculating the value of in-kind services provided by volunteers and contributions of materials, equipment, buildings, land, and space.

G. *Standards for grantees' financial management systems*. Standards are prescribed for financial management systems used for grant-supported activities. Federal agencies will not impose requirements other than for current, accurate, and complete disclosure of financial results; adequate identification of source and application of funds; effective control and accountability for funds and property; comparison of actual and budgeted amounts; minimizing time elapsing between receipt and expenditure of funds; a cost allocation plan; and overall organization audits performed at the direction of the grantee.

H. *Financial reporting requirements*. Four standard reporting forms are provided to replace the different forms previously required for each grant program.

   1. *Financial status report*—To report status of funds for all nonconstruction programs.
   2. *Federal cash transactions*—To monitor cash balances when funds are advanced to grantees by letter of credit or Treasury checks.
   3. *Request for advance or reimbursement*—For all nonconstruction programs when advance letter of credit or predetermined advance payments are not used. May be submitted monthly.
   4. *Outlay report and request for reimbursement*—For reimbursement on all construction programs. May be submitted monthly.

I. *Monitoring and reporting program performance*. Recipients will be held responsible for monitoring programs to assure that time schedules are met and that performance goals are achieved. Periodic reports of progress, documented with quantitative data when possible, will be required.[5] If goals are not met, or costs are exceeding budget, these conditions must be reported. Between reporting dates, grantees must report any unusual conditions or events that will affect achieving goals within the time period specified.

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4. The federal agency making the award determines which method of using grant program income will be followed.

5. These reports are submitted together with the financial status reports.

J. *Grant payment requirement.* A letter of credit will be used for all grants, except construction grants, for which it is optional, when there is a continued relationship of at least twelve months, when the payment for a year would exceed $120,000, and when the recipient's financial management system meets federal standards. Funds will be advanced when the annual amount is less than $120,000.[6] Reimbursement will be used when there is not an adequate financial management system.

K. *Budget revision procedures.* For nonconstruction grants, prior federal approval for budget revision must be obtained for the following reasons:
   1. There is a change in the program's scope or objective or a need for additional federal funding.
   2. The cumulative amount of transfers among object class categories or among programs, functions, or activities exceeds 5 percent or $100,000.[7]
   3. Indirect cost amounts are to be used for direct costs (if required by the federal agency) or if the budget revision contains items requiring A-87 approval.
   4. Recipients plan to transfer funds allocated for training to other categories of expenses.

   Construction grants need approval for revisions only in the case of (1). When federal funds are expected to exceed needs by more than 5 percent or $5,000, the federal agency must be notified.

L. *Grant closeout procedures.* Federal agencies must establish closeout procedures that provide for prompt payments by the grantor or prompt refunds by the grantee, reports within ninety days of completion, adjustment of the federal share, accounting for government property, and retaining the right of recovery until final audit. Federal agencies must also develop procedures to be followed when the grantee does not comply with the grant agreement and the grant is terminated.

M. *Standard forms for applying for federal assistance.* With one exception, all state, local, and Indian tribal governments applying for federal grants will use the forms outlined in this attachment. Most formula grants do not require grantees to apply for assistance on a project basis. Hence, these programs are not required to use the forms.

N. *Property management system.* Standards governing the use and disposition of federally financed property are prescribed. The grantee's property management procedures must provide for accurate records, biannual inventories, adequate maintenance and control, and proper sales procedures. Each federal agency must prescribe requirements

6. By Treasury check.

7. This occurs only when required by the federal grantor agency.

covering real property for grantees. Such requirements will cover, at a minimum, the following:

1. Vesting title
2. Use of property in other projects
3. Disposition after use

In general, after using the property, the grantee will request disposition instructions from the federal agency. The federal agency shall observe the following rules: The grantee may compensate the government and retain title, sell the property and pay the government, or transfer title for the property back to the government.[8]

O. *Procurement standards.* The attachment outlines four methods for making procurements under the terms and conditions of grants.

1. Small purchase procedures
2. Competitive sealed bids (formal advertising)
3. Competitive negotiation
4. Noncompetitive negotiation

8. Similar requirements are provided in detail for personal property.

Appendix D

The Single Audit Act of 1984

Short Title; Purpose

Section 1. (a) This Act may be cited as the "Single Audit Act of 1984".

(b) It is the purpose of this Act—

(1) to improve the financial management of State and local governments with respect to Federal financial assistance programs;

(2) to establish uniform requirements for audits of Federal financial assistance provided to State and local governments;

(3) to promote the efficient and effective use of audit resources; and

(4) to ensure that Federal departments and agencies, to the maximum extent practicable, rely upon and use audit work done pursuant to chapter 75 of title 31, United States Code (as added by this Act).

Amendment To Title 31, United States Code

Sec. 2 (a) Subtitle V of title 31, United States Code, is amended by adding at the end thereof the following new chapter:

Chapter 75—Requirements For Single Audits

"Sec.
"7501. Definitions.
"7502. Audit requirements; exemptions.
"7503. Relation to other audit requirements.
"7504. Cognizant agency responsibilities.
"7505. Regulations.
"7506. Monitoring responsibilities of the Comptroller General.
"7507. Effective date; report.

"§ 7501. Definitions

"As used in this chapter, the term—

"(1) 'cognizant agency' means a Federal agency which is assigned by the Director with the responsibility for implementing the requirements of this chapter with respect to a particular State or local government.

"(2) 'Comptroller General' means the Comptroller General of the United States.

"(3) 'Director' means the Director of the Office of Management and Budget.

"(4) 'Federal financial assistance' means assistance provided by a Federal agency in the form of grants, contracts, loans, loan guarantees, property, cooperative agreements, interest subsidies, insurance, or direct appropriations, but does not include direct Federal cash assistance to individuals.

"(5) 'Federal agency' has the same meaning as the term 'agency' in section 551(1) of title 5, United States Code.

"(6) 'generally accepted accounting principles' has the meaning specified in the generally accepted government auditing standards.

"(7) 'generally accepted government auditing standards' means the standards for audit of governmental organizations, programs, activities, and functions, issued by the Comptroller General.

"(8) 'independent auditor' means—

"(A) an external State or local government auditor who meets the independence standards included in generally accepted government auditing standards, or

"(B) a public accountant who meets such independence standards.

"(9) 'internal controls' means the plan of organization and methods and procedures adopted by management to ensure that—

"(A) resource use is consistent with laws, regulations, and policies;

"(B) resources are safeguarded against waste, loss, and misuse; and

"(C) reliable data are obtained, maintained, and fairly disclosed in reports.

"(10) 'Indian tribe' means any Indian tribe, band, nation, or other organized group or community, including any Alaskan Native village or regional or village corporation (as defined in, or established under, the Alaskan Native Claims Settlement Act) that is recognized by the United States as eligible for the special programs and services provided by the United States to Indians because of their status as Indians.

"(11) 'local government' means any unit of local government within a State, including a county, borough, municipality, city, town, township, parish, local public authority, special district, school district, intrastate district, council of governments, and any other instrumentality of local government.

"(12) 'major Federal assistance program' means any program for which total expenditures of Federal financial assistance by the State or local government during the applicable year exceed—

"(A) $20,000,000 in the case of a State or local government for which such total expenditures for all programs exceed $7,000,000,000;

"(B) $19,000,000 in the case of a State or local government for which such total expenditures for all programs exceed $6,000,000,000 but are less than or equal to $7,000,000,000;

"(C) $16,000,000 in the case of a State or local government for which such total expenditures for all programs exceed $5,000,000,000 but are less than or equal to $6,000,000,000;

"(D) $13,000,000 in the case of a State or local government for which such total expenditures for all programs exceed $4,000,000,000 but are less than or equal to $5,000,000,000;

"(E) $10,000,000 in the case of a State or local government for which such total expenditures for all programs exceed $3,000,000,000 but are less than or equal to $4,000,000,000;

"(F) $7,000,000 in the case of a State or local government for which such total expenditures for all programs exceed $2,000,000,000 but are less than or equal to $3,000,000,000;

"(G) $4,000,000 in the case of a State or local government for which such total expenditures for all programs exceed $1,000,000,000 but are less than or equal to $2,000,000,000;

"(H) $3,000,000 in the case of a State or local government for which such total expenditures for all programs exceed $100,000,000 but are less than or equal to $1,000,000,000; and

"(I) the larger of (i) $300,000, or (ii) 3 percent of such total expenditures for all programs, in the case of a State or local government for which such total expenditures for all programs exceed $100,000 but are less than or equal to $100,000,000.

"(13) 'public accountants' means those individuals who meet the qualification standards included in generally accepted government auditing standards for personnel performing government audits.

"(14) 'State' means any State of the United States, the District of Columbia, the Commonwealth of Puerto Rico, the Virgin Islands, Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and the Trust Territory of the Pacific Islands, any instrumentality thereof, any multi-State, regional, or interstate entity which has governmental functions, and any Indian tribe.

"(15) 'subrecipient' means any person or government department, agency, or establishment that receives Federal financial assistance through a State or local government, but does not include an individual that receives such assistance.

"§ 7502. Audit requirements; exemptions

"(a)(1)(A) Each State and local government which receives a total amount of Federal financial assistance equal to or in excess of $100,000 in any fiscal year of such government shall have an audit made for such fiscal year in accordance with the requirements of this chapter and the requirements of the regulations prescribed pursuant to section 7505 of this title.

"(B) Each State and local government that receives a total amount of Federal financial assistance which is equal to or in excess of $25,000 but less than $100,000 in any fiscal year of such government shall—

"(i) have an audit made for such fiscal year in accordance with the requirements of this chapter and the requirements of the regulations prescribed pursuant to section 7505 of this title; or

"(ii) comply with any applicable requirements concerning financial or financial and compliance audits contained in Federal statutes and regulations governing programs under which such Federal financial assistance is provided to that government.

"(C) Each State and local government that receives a total amount of Federal financial assistance which is less than $25,000 in any fiscal year of such government shall be exempt for such fiscal year from compliance with—

"(i) the audit requirements of this chapter; and

"(ii) any applicable requirements concerning financial or financial and compliance audits contained in Federal statutes and regulations governing programs under which such Federal financial assistance is provided to that government.

The provisions of clause (ii) of this subparagraph do not exempt a State or local government from compliance with any provision of a Federal statute or regulation that requires such government to maintain records concerning Federal financial assistance provided to such government or that permits a Federal agency or the Comptroller General access to such records.

"(2) For purposes of this section, a State or local government shall be considered to receive Federal financial assistance whether such assistance is received directly from a Federal agency or indirectly through another State or local government.

"(b)(1) Except as provided in paragraphs (2) and (3), audits conducted pursuant to this chapter shall be conducted annually.

"(2) If a State or local government is required—

"(A) by constitution or statute, as in effect on the date of enactment of this chapter, or

"(B) by administrative rules, regulations, guidelines, standards, or policies, as in effect on such date,

to conduct its audits less frequently than annually, the cognizant agency for such government shall, upon request of such government, permit the government to conduct its audits pursuant to this chapter biennially, except as provided in paragraph (3). Such audits shall cover both years within the biennial period.

"(3) Any State or local government that is permitted, under clause (B) of paragraph (2), to conduct its audits pursuant to this chapter biennially by reason of the requirements of a rule, regulation, guideline, standard, or policy, shall, for any of its fiscal years beginning after December 31, 1986, conduct such audits annually unless such State or local government codifies a requirement for biennial audits in its constitution or statutes by January 1, 1987. Audits conducted biennially under the provisions of this paragraph shall cover both years within the biennial period.

"(c) Each audit conducted pursuant to subsection (a) shall be conducted by an independent auditor in accordance with generally accepted government auditing standards, except that, for the purposes of this chapter, such standards shall not be construed to require economy and efficiency audits, program results audits, or program evaluations.

"(d)(1) Each audit conducted pursuant to subsection (a) for any fiscal year shall cover the entire State or local government's operations except that, at the option of such government—

"(A) such audit may, except as provided in paragraph (5), cover only each department, agency, or establishment which received, expended, or otherwise administered Federal financial assistance during such fiscal year; and

"(B) such audit may exclude public hospitals and public colleges and universities.

"(2) Each such audit shall encompass the entirety of the financial operations of such government or of such department, agency, or establishment, whichever is applicable, and shall determine and report whether—

"(A)(i) the financial statements of the government, department, agency, or establishment present fairly its financial position and the results of its financial operations in accordance with generally accepted accounting principles; and

"(ii) the government, department, agency, or establishment has complied with laws and regulations that may have a material effect upon the financial statements;

"(B) the government, department, agency, or establishment has internal control systems to provide reasonable assurance that it is managing Federal financial assistance programs in compliance with applicable laws and regulations; and

"(C) the government, department, agency, or establishment has complied with laws and regulations that may have a material effect upon each major Federal assistance program.

In complying with the requirements of subparagraph (C), the independent auditor shall select and test a representative number of transactions from each major Federal assistance program.

"(3) Transactions selected from Federal assistance programs, other than major Federal assistance programs, pursuant to the requirements of paragraphs (2)(A) and (2)(B) shall be tested for compliance with Federal laws and regulations that apply to such transactions. Any noncompliance found in such transactions by the independent auditor in making determinations required by this paragraph shall be reported.

"(4) The number of transactions selected and tested under paragraphs (2) and (3), the selection and testing of such transactions, and the determinations required by such paragraphs shall be based on the professional judgment of the independent auditor.

"(5) Each State or local government which, in any fiscal year of such government, receives directly from the Department of the Treasury a total of $25,000 or more under chapter 67 of this title (relating to general revenue sharing) and which is required to conduct an audit pursuant to this chapter for such fiscal year shall not have the option provided by paragraph (1)(A) for such fiscal year.

"(6) A series of audits of individual departments, agencies, and establishments for the same fiscal year may be considered to be an audit for the purpose of this chapter.

"(e)(1) Each State and local government subject to the audit requirements of this chapter, which receives Federal financial assistance and provides $25,000 or more of such assistance in any fiscal year to a subrecipient, shall—

"(A) if the subrecipient conducts an audit in accordance with the requirements of this chapter, review such audit and ensure that prompt and appropriate corrective action is taken on instances of material noncompliance with applicable laws and regulations with respect to Federal financial assistance provided to the subrecipient by the State or local government; or

"(B) if the subrecipient does not conduct an audit in accordance with the requirements of this chapter—

"(i) determine whether the expenditures of Federal financial assistance provided to the subrecipient by the State or local government are in accordance with applicable laws and regulations; and

"(ii) ensure that prompt and appropriate corrective action is taken on instances of material noncompliance with applicable laws and regulations with respect to Federal financial assistance provided to the subrecipient by the State or local government.

"(2) Each such State and local government shall require each subrecipient of Federal assistance through such government to permit, as a condition of receiving funds from such assistance, the independent auditor of the State or local government to have such access to the subrecipient's records and financial statements as may be necessary for the State or local government to comply with this chapter.

"(f) The report made on any audit conducted pursuant to this section shall, within thirty days after completion of such report, be transmitted to the appropriate Federal officials and made available by the State or local government for public inspection.

(g) If an audit conducted pursuant to this section finds any material noncompliance with applicable laws and regulations by, or material weakness in the internal controls of, the State or local government with respect to the matters described in subsection (d)(2), the State or local government shall submit to appropriate Federal officials a plan for corrective action to eliminate such material noncompliance or weakness or a statement describing the reasons that corrective action is not necessary. Such plan shall be consistent with the audit resolution standard promulgated by the Comptroller General (as part of the standards for internal controls in the Federal Government) pursuant to section 3512(b) of this title.

"§ 7503. Relation to other audit requirements

"(a) An audit conducted in accordance with this chapter shall be in lieu of any financial or financial and compliance audit of an individual Federal assistance program which a State or local government is required to conduct under any other Federal law or regulation. To the extent that such audit provides a Federal agency with the information it requires to carry out its responsibilities under Federal law or regulation, a Federal agency shall rely upon and use that information and plan and conduct its own audits accordingly in order to avoid a duplication of effort.

"(b) Notwithstanding subsection (a), a Federal agency shall conduct any additional audits which are necessary to carry out its responsibilities under Federal law or regulation. The provisions of this chapter do not authorize any State or local government (or subrecipient thereof) to constrain, in any manner, such agency from carrying out such additional audits.

"(c) The provisions of this chapter do not limit the authority of Federal agencies to conduct, or enter into contracts for the conduct of, audits and evaluations of Federal financial assistance programs, nor limit the authority of any Federal agency Inspector General or other Federal audit official.

"(d) Subsection (a) shall apply to a State or local government which conducts an audit in accordance with this chapter even though it is not required by section 7502(a) to conduct such audit.

"(e) A Federal agency that performs or contracts for audits in addition to the audits conducted by recipients pursuant to this chapter shall, consistent with other applicable law, arrange for funding the cost of such additional audits. Such additional audits include economy and efficiency audits, program results audits, and program evaluations.

"§ 7504. Cognizant agency responsibilities

"(a) The Director shall designate cognizant agencies for audits conducted pursuant to this chapter.

"(b) A cognizant agency shall—

"(1) ensure that audits are made in a timely manner and in accordance with the requirements of this chapter;

"(2) ensure that the audit reports and corrective action plans made pursuant to section 7502 of this title are transmitted to the appropriate Federal officials; and

"(3)(A) coordinate, to the extent practicable, audits done by or under contract with Federal agencies that are in addition to the audits conducted pursuant to this chapter; and (B) ensure that such additional audits build upon the audits conducted pursuant to this chapter.

"§ 7505. Regulations

"(a) The Director, after consultation with the Comptroller General and appropriate Federal, State, and local government officials, shall prescribe policies, procedures, and guidelines to implement this chapter. Each Federal agency shall promulgate such amendments to its regulations as may be necessary to conform such regulations to the requirements of this chapter and of such policies, procedures, and guidelines.

"(b)(1) The policies, procedures, and guidelines prescribed pursuant to subsection (a) shall include criteria for determining the appropriate charges to programs of Federal financial assistance for the cost of audits. Such criteria shall prohibit a State or local government which is required to conduct an audit pursuant to this chapter from charging to any such program (A) the cost of any financial or financial and compliance audit which is not conducted in accordance with this chapter, and (B) more than a reasonably proportionate share of the cost of any such audit that is conducted in accordance with this chapter.

"(2) The criteria prescribed pursuant to paragraph (1) shall not, in the absence of documentation demonstrating a higher actual cost, permit (A) the ratio of (i) the total charges by a government to Federal financial assistance programs for the cost of audits performed pursuant to this chapter, to (ii) the total cost of such audits, to exceed (B) the ratio of (i) total Federal financial assistance expended by such government during the applicable fiscal year or years, to (ii) such government's total expenditures during such fiscal year or years.

"(c) Such policies, procedures, and guidelines shall include such provisions as may be necessary to ensure that small business concerns and business concerns owned and controlled by socially and economically disadvantaged individuals will have the opportunity to participate in the performance of contracts awarded to fulfill the audit requirements of this chapter.

"§ 7506. Monitoring responsibilities of the Comptroller General

"The Comptroller General shall review provisions requiring financial or financial and compliance audits of recipients of Federal assistance that are contained in bills and resolutions reported by the committees of the Senate and the House of Representatives. If the Comptroller General determines that a bill or resolution contains provisions that are inconsistent with the requirements of this chapter, the Comptroller General shall, at the earliest practicable date, notify in writing—

"(1) the committee that reported such bill or resolution; and

"(2)(A) the Committee on Governmental Affairs of the Senate (in the case of a bill or resolution reported by a committee of the Senate); or

"(B) the Committee on Government Operations of the House of Representatives (in the case of a bill or resolution reported by a committee of the House of Representatives).

"§ 7507. Effective date; report

"(a) This chapter shall apply to any State or local government with respect to any of its fiscal years which begin after December 31, 1984.

"(b) The Director, on or before May 1, 1987, and annually thereafter, shall submit to each House of Congress a report on operations under this chapter. Each such report shall specifically identify each Federal agency or State or local government which is failing to comply with this chapter."

(b) The provisions of this Act shall not diminish or otherwise affect the authority of the Tennessee Valley Authority to conduct its own audits of any matter involving funds disbursed by the Tennessee Valley Authority.

(c) The table of chapters for subtitle V of title 31, United States Code, is amended by inserting after the item relating to chapter 73 the following new item:

"75. Requirements for Single Audits .... 7501".

Appendix E

OMB Circular No. A-128

April 12, 1985

TO THE HEADS OF EXECUTIVE DEPARTMENTS AND ESTABLISHMENTS

SUBJECT: Audits of State and Local Governments.

1. *Purpose.* This Circular is issued pursuant to the Single Audit Act of 1984, P.L. 98-502. It establishes audit requirements for State and Local governments that receive Federal aid, and defines Federal responsibilities for implementing and monitoring those requirements.

2. *Supersession.* The Circular supersedes Attachment P, "Audit Requirements," of Circular A-102, "Uniform requirements for grants to State and local governments."

3. *Background.* The Single Audit Act builds upon earlier efforts to improve audits of Federal aid programs. The Act requires State or local governments that receive $100,000 or more a year in Federal funds to have an audit made for that year. Section 7505 of the Act requires the Director of the Office of Management and Budget to prescribe policies, procedures and guidelines to implement the Act. It specifies that the Director shall designate "cognizant" Federal agencies, determine criteria for making appropriate charges to Federal programs for the cost of audits, and provide procedures to assure that small firms or firms owned and controlled by disadvantaged individuals have the opportunity to participate in contracts for single audits.

4. *Policy.* The Single Audit Act requires the following:

   a. State or local governments that receive $100,000 or more a year in Federal financial assistance shall have an audit made in accordance with this Circular.

   b. State or local governments that receive between $25,000 and $100,000 a year shall have an audit made in accordance with this Circular, or in accordance with Federal laws and regulations governing the programs they participate in.

   c. State or local governments that receive less than $25,000 a year shall be exempt from compliance with the Act and other Federal audit requirements. These State and local governments shall be governed by audit requirements prescribed by State or local law or regulation.

   d. Nothing in this paragraph exempts State or local governments from maintaining records of Federal financial assistance or from providing access to such records to Federal agencies, as provided for in Federal law or in Circular A-102, "Uniform requirements for grants to State or local governments."

5. *Definitions*. For the purposes of this Circular the following definitions from the Single Audit Act apply:

a. "Cognizant agency" means the Federal agency assigned by the Office of Management and Budget to carry out the responsibilities described in paragraph 11 of this Circular.

b. "Federal financial assistance" means assistance provided by a Federal agency in the form of grants, contracts, cooperative agreements, loans, loan guarantees, property, interest subsidies, insurance, or direct appropriations, but does not include direct Federal cash assistance to individuals. It includes awards received directly from Federal agencies, or indirectly through other units of State and local governments.

c. "Federal agency" has the same meaning as the term 'agency' in section 551(1) of Title 5, United States Code.

d. "Generally accepted accounting principles" has the meaning specified in the generally accepted government auditing standards.

e. "Generally accepted government auditing standards" means the *Standards for Audit of Government Organizations, Programs, Activities, and Functions*, developed by the Comptroller General, dated February 27, 1981.

f. "Independent auditor" means:

(1) a State or local government auditor who meets the independence standards specified in generally accepted government auditing standards; or

(2) a public accountant who meets such independence standards.

g. "Internal controls" means the plan of organization and methods and procedures adopted by management to ensure that:

(1) resource use is consistent with laws, regulations, and policies;

(2) resources are safeguarded against waste, loss, and misuse; and

(3) reliable data are obtained, maintained, and fairly disclosed in reports.

h. "Indian tribe" means any Indian tribe, band, nations, or other organized group or community, including any Alaskan Native village or regional or village corporations (as defined in, or established under, the Alaskan Native Claims Settlement Act) that is recognized by the United States as eligible for the special programs and services provided by the United States to Indians because of their status as Indians.

i. "Local government" means any unit of local government within a State, including a county, a borough, municipality, city, town, township, parish, local public authority, special district, school district, intrastate district, council of governments, and any other instrumentality of local government.

j. "Major Federal Assistance Program," as defined by P.L. 98-502, is described in the Attachment to this Circular.

k. "Public accountants" means those individuals who meet the qualification standards included in generally accepted government auditing standards for personnel performing government audits.

l. "State" means any State of the United States, the District of Columbia, the Commonwealth of Puerto Rico, the Virgin Islands, Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and the Trust Territory of the Pacific Islands, any instrumentality thereof, and any multi-State, regional, or interstate entity that has governmental functions and any Indian tribe.

m. "Subrecipient" means any person or government department, agency, or establishment that receives Federal financial assistance to carry out a program through a State or local government, but does not include an individual that is a beneficiary of such a program. A subrecipient may also be a direct recipient of Federal financial assistance.

6. *Scope of audit.* The Single Audit Act provides that:

a. The audit shall be made by an independent auditor in accordance with generally accepted government auditing standards covering financial and compliance audits.

b. The audit shall cover the entire operations of a State or local government or, at the option of that government, it may cover departments, agencies or establishments that received, expended, or otherwise administered Federal financial assistance during the year. However, if a State or local government receives $25,000 or more in General Revenue Sharing Funds in a fiscal year, it shall have an audit of its entire operations. A series of audits of individual departments, agencies, and establishments for the same fiscal year may be considered a single audit.

c. Public hospitals and public colleges and universities may be excluded from State and local audits and the requirements of this Circular. However, if such entities are excluded, audits of these entities shall be made in accordance with statutory requirements and the provisions of Circular A-110, "Uniform requirements for grants to universities, hospitals, and other nonprofit organizations."

d. The auditor shall determine whether:

(1) the financial statements of the government, department, agency or establishment present fairly its financial position and the results of its financial operations in accordance with generally accepted accounting principles;

(2) the organization has internal accounting and other control systems to provide reasonable assurance that it is managing Federal financial assistance programs in compliance with applicable laws and regulations; and

(3) the organization has complied with laws and regulations that may have material effect on its financial statements and on each major Federal assistance program.

7. *Frequency of audit.* Audits shall be made annually unless the State or local government has, by January 1, 1987, a constitutional or statutory requirement for less frequent audits. For those governments, the cogni-

zant agency shall permit biennial audits, covering both years, if the government so requests. It shall also honor requests for biennial audits by governments that have an administrative policy calling for audits less frequent than annual, but only for fiscal years beginning before January 1, 1987.

8. *Internal control and compliance reviews.* The Single Audit Act requires that the independent auditor determine and report on whether the organization has internal control systems to provide reasonable assurance that it is managing Federal assistance programs in compliance with applicable laws and regulations.

a. *Internal control review.* In order to provide this assurance the auditor must make a study and evaluation of internal control systems used in administering Federal assistance programs. The study and evaluation must be made whether or not the auditor intends to place reliance on such systems. As part of this review, the auditor shall:

(1) Test whether these internal control systems are functioning in accordance with prescribed procedures.

(2) Examine the recipient's system for monitoring subrecipients and obtaining and acting on subrecipient audit reports.

b. *Compliance review.* The law also requires the auditor to determine whether the organization has complied with laws and regulations that may have a material effect on each major Federal assistance program.

(1) In order to determine which major programs are to be tested for compliance, State and local governments shall identify in their accounts all Federal funds received and expended and the programs under which they were received. This shall include funds received directly from Federal agencies and through other State and local governments.

(2) The review must include the selection and testing of a representative number of charges from each major Federal assistance program. The selection and testing of transactions shall be based on the auditor's professional judgment considering such factors as the amount of expenditures for the program and the individual awards; the newness of the program or changes in its conditions; prior experience with the program, particularly as revealed in audits and other evaluations (e.g., inspections, program reviews); the extent to which the program is carried out through subrecipients; the extent to which the program contracts for goods or services; the level to which the program is already subject to program reviews or other forms of independent oversight; the adequacy of the controls for ensuring compliance; the expectation of adherence or lack of adherence to the applicable laws and regulations; and the potential impact of adverse findings.

(a) In making the test of transactions, the auditor shall determine whether:

—the amounts reported as expenditures were for allowable services, and

—the records show that those who received services or benefits were eligible to receive them.

(b) In addition to transaction testing, the auditor shall determine whether:

—matching requirements, levels of effort and earmarking limitations were met,

—Federal financial reports and claims for advances and reimbursements contain information that is supported by the books and records from which the basic financial statements have been prepared, and

—amounts claimed or used for matching were determined in accordance with OMB Circular A-87, "Cost principles for State and local governments," and Attachment F of Circular A-102, "Uniform requirements for grants to State and local governments."

(c) The principal compliance requirements of the largest Federal aid programs may be ascertained by referring to the *Compliance Supplement for Single Audits of State and Local Governments*, issued by OMB and available from the Government Printing Office. For those programs not covered in the Compliance Supplement, the auditor may ascertain compliance requirements by researching the statutes, regulations, and agreements governing individual programs.

(3) Transactions related to other Federal assistance programs that are selected in connection with examinations of financial statements and evaluations of internal controls shall be tested for compliance with Federal laws and regulations that apply to such transactions.

9. *Subrecipients*. State or local governments that receive Federal financial assistance and provide $25,000 or more of it in a fiscal year to a subrecipient shall:

a. determine whether State or local subrecipients have met the audit requirements of this Circular and whether subrecipients covered by Circular A-110, "Uniform requirements for grants to universities, hospitals, and other nonprofit organizations," have met that requirement;

b. determine whether the subrecipient spent Federal assistance funds provided in accordance with applicable laws and regulations. This may be accomplished by reviewing an audit of the subrecipient made in accordance with this Circular, Circular A-110, or through other means (e.g., program reviews) if the subrecipient has not yet had such an audit;

c. ensure that appropriate corrective action is taken within six months after receipt of the audit report in instances of noncompliance with Federal laws and regulations;

d. consider whether subrecipient audits necessitate adjustment of the recipient's own records; and

e. require each subrecipient to permit independent auditors to have access to the records and financial statements as necessary to comply with this Circular.

10. *Relation to other audit requirements*. The Single Audit Act provides that an audit made in accordance with this Circular shall be in lieu of any financial or financial compliance audit required under individual Federal assistance programs. To the extent that a single audit provides Federal

agencies with information and assurances they need to carry out their overall responsibilities, they shall rely upon and use such information. However, a Federal agency shall make any additional audits which are necessary to carry out its responsibilities under Federal law and regulation. Any additional Federal audit effort shall be planned and carried out in such a way as to avoid duplication.

a. The provisions of this Circular do not limit the authority of Federal agencies to make, or contract for audits and evaluations of Federal financial assistance programs, nor do they limit the authority of any Federal agency Inspector General or other Federal audit official.

b. The provisions of this Circular do not authorize any State or local government or subrecipient thereof to constrain Federal agencies, in any manner, from carrying out additional audits.

c. A Federal agency that makes or contracts for audits in addition to the audits made by recipients pursuant to this Circular shall, consistent with other applicable laws and regulations, arrange for funding the cost of such additional audits. Such additional audits include economy and efficiency audits, program results audits, and program evaluations.

11. *Cognizant agency responsibilities.* The Single Audit Act provides for cognizant Federal agencies to oversee the implementation of this Circular.

a. The Office of Management and Budget will assign cognizant agencies for States and their subdivisions and larger local governments and their subdivisions. Other Federal agencies may participate with an assigned cognizant agency, in order to fulfill the cognizance responsibilities. Smaller governments not assigned a cognizant agency will be under the general oversight of the Federal agency that provides them the most funds whether directly or indirectly.

b. A cognizant agency shall have the following responsibilities:

(1) Ensure that audits are made and reports are received in a timely manner and in accordance with the requirements of this Circular.

(2) Provide technical advice and liaison to State and local governments and independent auditors.

(3) Obtain or make quality control reviews of selected audits made by non-Federal audit organizations, and provide the results, when appropriate, to other interested organizations.

(4) Promptly inform other affected Federal agencies and appropriate Federal law enforcement officials of any reported illegal acts or irregularities. They should also inform State or local law enforcement and prosecuting authorities, if not advised by the recipient, of any violation of law within their jurisdiction.

(5) Advise the recipient of audits that have been found not to have met the requirements set forth in this Circular. In such instances, the recipient will be expected to work with the auditor to take corrective action. If corrective action is not taken, the cognizant agency shall notify the recipient and Federal awarding agencies of the facts and make recommendations for followup action. Major inadequacies or repetitive sub-

standard performance of independent auditors shall be referred to appropriate professional bodies for disciplinary action.

(6) Coordinate, to the extent practicable, audits made by or for Federal agencies that are in addition to the audits made pursuant to this Circular; so that the additional audits build upon such audits.

(7) Oversee the resolution of audit findings that affect the programs of more than one agency.

12. *Illegal acts or irregularities.* If the auditor becomes aware of illegal acts or other irregularities, prompt notice shall be given to recipient management officials above the level of involvement. (See also paragraph 13(a) (3) below for the auditor's reporting responsibilities.) The recipient, in turn, shall promptly notify the cognizant agency of the illegal acts or irregularities and of proposed and actual actions, if any. Illegal acts and irregularities include such matters as conflicts of interest, falsification of records or reports, and misappropriations of funds or other assets.

13. *Audit reports.* Audit reports must be prepared at the completion of the audit. Reports serve many needs of State and local governments as well as meeting the requirements of the Single Audit Act.

a. The audit report shall state that the audit was made in accordance with the provisions of this Circular. The report shall be made up of at least:

(1) The auditor's report on financial statements and on a schedule of Federal assistance; the financial statements; and a schedule of Federal assistance, showing the total expenditures for each Federal assistance program as identified in the *Catalog of Federal Domestic Assistance.* Federal programs or grants that have not been assigned a catalog number shall be identified under the caption "other Federal assistance."

(2) The auditor's report on the study and evaluation of internal control systems must identify the organization's significant internal accounting controls, and those controls designed to provide reasonable assurance that Federal programs are being managed in compliance with laws and regulations. It must also identify the controls that were evaluated, the controls that were not evaluated, and the material weaknesses identified as a result of the evaluation.

(3) The auditor's report on compliance containing:

—a statement of positive assurance with respect to those items tested for compliance, including compliance with law and regulations pertaining to financial reports and claims for advances and reimbursements;

—negative assurance on those items not tested;

—a summary of all instances of noncompliance; and

—an identification of total amounts questioned, if any, for each Federal assistance award, as a result of noncompliance.

b. The three parts of the audit report may be bound into a single report, or presented at the same time as separate documents.

c. All fraud abuse, or illegal acts or indications of such acts, including all questioned costs found as the result of these acts that auditors become aware of, should normally be covered in a separate written report submitted in accordance with paragraph 13f.

d. In addition to the audit report, the recipient shall provide comments on the findings and recommendations in the report, including a plan for corrective action taken or planned and comments on the status of corrective action taken on prior findings. If corrective action is not necessary, a statement describing the reason it is not should accompany the audit report.

e. The reports shall be made available by the State or local government for public inspection within 30 days after the completion of the audit.

f. In accordance with generally accepted government audit standards, reports shall be submitted by the auditor to the organization audited and to those requiring or arranging for the audit. In addition, the recipient shall submit copies of the reports to each Federal department or agency that provided Federal assistance funds to the recipient. Subrecipients shall submit copies to recipients that provided them Federal assistance funds. The reports shall be sent within 30 days after the completion of the audit, but no later than one year after the end of the audit period unless a longer period is agreed to with the cognizant agency.

g. Recipients of more than $100,000 in Federal funds shall submit one copy of the audit report within 30 days after issuance to a central clearinghouse to be designated by the Office of Management and Budget. The clearinghouse will keep completed audits on file and follow up with State and local governments that have not submitted required audit reports.

h. Recipients shall keep audit reports on file for three years from their issuance.

14. *Audit resolution*. As provided in paragraph 11, the cognizant agency shall be responsible for monitoring the resolution of audit findings that affect the programs of more than one Federal agency. Resolution of findings that relate to the programs of a single Federal agency will be the responsibility of the recipient and that agency. Alternate arrangements may be made on a case-by-case basis by agreement among the agencies concerned.

Resolution shall be made within six months after receipt of the report by the Federal departments and agencies. Corrective action should proceed as rapidly as possible.

15. *Audit workpapers and reports*. Workpapers and reports shall be retained for a minimum of three years from the date of the audit report, unless the auditor is notified in writing by the cognizant agency to extend the retention period. Audit workpapers shall be made available upon request to the cognizant agency or its designee or the General Accounting Office, at the completion of the audit.

16. *Audit costs*. The cost of audits made in accordance with the provisions of this Circular are allowable charges to Federal assistance programs.

a. The charges may be considered a direct cost or an allocated indirect cost, determined in accordance with the provision of Circular A-87, "Cost principles for State and local governments."

b. Generally, the percentage of costs charged to Federal assistance programs for a single audit shall not exceed the percentage that Federal funds expended represent of total funds expended by the recipient during the fiscal year. The percentage may be exceeded, however, if appropriate documentation demonstrates higher actual cost.

17. *Sanctions*. The Single Audit Act provides that no cost may be charged to Federal assistance programs for audits required by the Act that are not made in accordance with this Circular. In cases of continued inability or unwillingness to have a proper audit, Federal agencies must consider other appropriate sanctions including:

—withholding a percentage of assistance payments until the audit is completed satisfactorily

—withholding or disallowing overhead costs, and

—suspending the Federal assistance agreement until the audit is made.

18. *Auditor selection*. In arranging for audit services State and local governments shall follow the procurement standards prescribed by Attachment O of Circular A-102, "Uniform requirements for grants to State and local governments." The standards provide that while recipients are encouraged to enter into intergovernmental agreements for audit and other services, analysis should be made to determine whether it would be more economical to purchase the services from private firms. In instances where use of such intergovernmental agreements are required by State statutes (e.g., audit services) these statutes will take precedence.

19. *Small and minority audit firms*. Small audit firms and audit firms owned and controlled by socially and economically disadvantaged individuals shall have the maximum practicable opportunity to participate in contracts awarded to fulfill the requirements of this Circular. Recipients of Federal assistance shall take the following steps to further this goal:

a. Assure that small audit firms and audit firms owned and controlled by socially and economically disadvantaged individuals are used to the fullest extent practicable.

b. Make information on forthcoming opportunities available and arrange timeframes for the audit so as to encourage and facilitate participation by small audit firms and audit firms owned and controlled by socially and economically disadvantaged individuals.

c. Consider in the contract process whether firms competing for larger audits intend to subcontract with small audit firms and audit firms owned and controlled by socially and economically disadvantaged individuals.

d. Encourage contracting with small audit firms or audit firms owned and controlled by socially and economically disadvantaged individuals which have traditionally audited government programs and, in such cases where this is not possible, assure that these firms are given consideration for audit subcontracting opportunities.

e. Encourage contracting with consortiums of small audit firms as described in paragraph (a) above when a contract is too large for an individual small audit firm or audit firm owned and controlled by socially and economically disadvantaged individuals.

f. Use the services and assistance, as appropriate, of such organizations as the Small Business Administration in the solicitation and utilization of small audit firms or audit firms owned and controlled by socially and economically disadvantaged individuals.

20. *Reporting.* Each Federal agency will report to the Director of OMB on or before March 1, 1987, and annually thereafter on the effectiveness of State and local governments in carrying out the provisions of this Circular. The report must identify each State or local government or Indian tribe that, in the opinion of the agency, is failing to comply with the Circular.

21. *Regulations.* Each Federal agency shall include the provisions of this Circular in its regulations implementing the Single Audit Act.

22. *Effective date.* This Circular is effective upon publication and shall apply to fiscal years of State and local governments that begin after December 31, 1984. Earlier implementation is encouraged. However, until it is implemented, the audit provisions of Attachment P to Circular A-102 shall continue to be observed.

23. *Inquiries.* All questions or inquiries should be addressed to Financial Management Division, Office of Management and Budget, telephone number 202/395-3993.

24. *Sunset review date.* This Circular shall have an independent policy review to ascertain its effectiveness three years from the date of issuance.

David A. Stockman
Director

Circular A-128 Attachment

Definition of Major Program as Provided in P.L. 98-502

"Major Federal Assistance Program," for State and local governments having Federal assistance expenditures between $100,000 and $100,000,000, means any program for which Federal expenditures during the applicable year exceed the larger of $300,000, or 3 percent of such total expenditures.

Where total expenditures of Federal assistance exceed $100,000,000, the following criteria apply:

Total Expenditures of Federal Financial Assistance for All Programs		*Major Federal Assistance Program Means any Program That Exceeds*
more than	*but less than*	
$100 million	1 billion	$ 3 million
1 billion	2 billion	4 million
2 billion	3 billion	7 million
3 billion	4 billion	10 million
4 billion	5 billion	13 million
5 billion	6 billion	16 million
6 billion	7 billion	19 million
over 7 billion		20 million

Appendix F

Acronyms and Abbreviations

ACNO. Audits of Certain Nonprofit Organizations, AICPA
ACU. Audits of Colleges and Universities, AICPA
APB. Accounting Principles Board
ASBO. Association of School Business Officials
AVHWO. Audits of Voluntary Health and Welfare Organizations, AICPA
CAFR. Comprehensive Annual Financial Report
CUFR, CUFS. Component Unit Financial Report/Financial Statements
EEOC. Equal Employment Opportunity Commission
ERISA. Employee Retirement Income Security Act
FAF. Financial Accounting Foundation
FASB. Financial Accounting Standards Board
GAAFR. Governmental Accounting, Auditing, and Financial Reporting—MFOA 1980
GAAP. Generally Accepted Accounting Principles
GAAS. Generally Accepted Auditing Standards
GAGAS. Generally Accepted Governmental Auditing Standards
GAO. General Accounting Office, United States
GASAC. Governmental Accounting Standards Advisory Council
GASB. Governmental Accounting Standards Board
GASBOC. Governmental Accounting Standards Board Organization Committee
GFAAG. General Fixed Assets Account Group
GFOA. Government Finance Officers Association of the United States and Canada
GLTDAG. General Long-Term Debt Account Group
GPFS. General Purpose Financial Statements
HAG. Hospital Audit Guide, AICPA
HUD. Housing and Urban Development, U.S. Department of
IBNR. Incurred But Not Reported (Claims)
MFOA. Municipal Finance Officers Association of the United States and Canada (now GFOA)
NCGA. National Council on Governmental Accounting
OMB. Office of Management and Budget, United States
ORS. Office of Revenue Sharing, U.S. Treasury Department
PAPSG. Preferred Accounting Practices for State Governments, NCGA and Council of State Governments
PERS. Public Employees Retirement System

SAS. Statement on Auditing Standards
SOP. Statement of Position by Committees of the AICPA
USDA. U.S. Department of Agriculture
YELLOW BOOK. Standards for Audit of Governmental Organizations, Programs, Activities and Functions issued by Comptroller General of the U.S., 1981

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