100 Introduction

100.1 *PPC's Guide to Audits of Local Governments* (the *Guide*) discusses in detail the requirements for audits of governmental entities. It covers the following types of interrelated auditing requirements:

- American Institute of Certified Public Accountants (AICPA) generally accepted auditing standards (GAAS).
- *Government Auditing Standards* issued by the Comptroller General of the United States (the Yellow Book).
- The Single Audit Act and Office of Management and Budget's (OMB) *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance) (also referred to as Single Audits). [1]

The three types of auditing requirements build on each other. That is, an auditor performing a Yellow Book audit also has to follow GAAS. An auditor performing a Single Audit also has to perform a Yellow Book audit.

100.2 This *Guide* provides a streamlined, technically sound audit approach for governmental entities. It provides auditors a flexible, adaptable audit process that is thorough, yet practical; effective; and efficient. The audit approach in this *Guide* enhances audit quality by ensuring compliance with the auditing standards. Further, auditors can consistently apply this effective audit process across all governmental audit engagements, which helps to ensure compliance with the firm's system of quality control and minimize firm risk and legal liability exposure.

100.3 The *Guide* includes—

- Audit programs that can be easily tailored to address the risks associated with your individual audit engagements.
- A complete, up-to-date set of easy-to-use practice aids.
- Practical, “how to” text guidance and answers to your governmental auditing questions.

100.4 This *Guide* shows the auditor of a local governmental unit how to plan and conduct effective audits that meet professional standards without unnecessary and unproductive procedures. Auditors who are familiar with *PPC's Guide to Audits of Nonpublic Companies* will see similarities in this *Guide*, which is organized in a similar but not identical fashion. Rather, this *Guide* builds on the guidance in *PPC's Guide to Audits of Nonpublic Companies* and tailors much of that guidance to specific governmental audit situations. While this *Guide* makes some references to *PPC's Guide to*

Audits of Nonpublic Companies, it is designed to be freestanding and used independently.

Governmental Units Covered and Not Covered by This *Guide*

100.5 *PPC's Guide to Audits of Local Governments* provides guidance most particularly applicable to cities, towns, townships, boroughs, villages, and school districts, which together constitute over half the total number of governmental units in the United States. It is generally applicable to the other types of governmental units, but those other units also have unique characteristics or accounting or auditing concerns that are not considered in this *Guide*. It is important to note that the financial statements of a city, town, etc., might have to include the operations of special districts or other organizations to conform to GAAP when certain conditions are met. Thus, the auditor might need to refer to specialized accounting and auditing literature for additional guidance. Some of those sources are:

- AICPA Audit and Accounting Guide, *Health Care Entities*.

- AICPA Audit and Accounting Guide, *Not-For-Profit Entities* (includes libraries, museums, and zoos, which may be operated in the public sector).

- AICPA Audit and Accounting Guide, *Employee Benefit Plans*. (The accounting provisions of this guide are not intended for governmental employee benefit plans; however, portions of the guide may be useful to auditors of government plans.)

100.6 While most of the accounting and auditing guidance contained in this *Guide* can easily be used as a basis for auditing state governments or state agencies, it is not a focus of the *Guide*. Audits of the federal government and federal agencies are beyond the scope of this *Guide*.

What Is a Governmental Unit?

100.7 **Definition** According to Paragraph 1.01 of the AICPA Audit and Accounting Guide, *State and Local Governments* (SLG), *governmental organizations* are defined as follows:

> Public corporations and corporate and politic bodies are governmental entities. Other entities, having one or more of the following characteristics, are also governmental organizations:
>
> - Popular election of officers or appointment (or approval) of a controlling majority of the members of the organization's governing body by officials of one or more state or local governments.
>
> - The potential for a government to unilaterally dissolve the organization with its net assets/position reverting to a government.
>
> - The power to levy taxes.
>
> Furthermore, entities are presumed to be governmental if they have the ability to issue directly (rather than through a state or municipal authority) debt that pays interest exempt from federal taxation. However, entities possessing only that ability (to issue tax-exempt debt) and none of the other governmental characteristics may rebut the presumption that they are governmental if their determination is supported by compelling,

relevant evidence.

100.8 **Types of Governmental Units.** According to the U.S. Census Bureau, there are approximately 90,000 state and local governmental entities in the United States. These are categorized as either general governments or special purpose governments. A *general government* is one which provides a range of services. A *special purpose government* is a legally separate entity that performs only one (or a few) specific activities. There are numerous types of special purpose governments, such as assessment districts, school districts [2], utilities, public employee retirement systems, governmental external investment pools, etc.

100.9 **Common Examples** Most governmental entities will clearly fit into the first sentence of the definition in paragraph 100.7. *Black's Law Dictionary* describes a public corporation as a municipality or a governmental corporation that has been created to administer public affairs or as an instrumentality of the state, founded and owned in the public interest. The following entities are common examples of governmental entities:

a. States, territories of the United States, and the District of Columbia.

b. Entities created by or under a state constitution, statute, statutory enabling legislation, or other local ordinance, including—

(1) Cities.

(2) Counties.

(3) Towns.

(4) Townships.

(5) Villages.

(6) Parishes.

(7) Boroughs.

(8) School districts.

(9) Special districts.

(10) Public authorities.

c. Entities considered to be a “municipal corporation” because they are declared by statute to be a “public corporation” or a “body corporate and politic.” Legally separate special-purpose entities may be so designated to avoid limitations or requirements placed on the general government, such as limitations on debt issuance or civil service requirements.

100.10 **Checklist for Determining Whether an Entity Is Governmental** ALG-CX-1.8 can be used as an aid in determining whether an entity should be accounted for as a governmental entity based on the guidance discussed in the preceding paragraphs. Auditors of entities determined to be nonprofit organizations ought to consult *PPC's Guide to Audits of Nonprofit Organizations*.

Differences between Governmental Units and Business Enterprises

100.11 Governmental units differ from business enterprises in several important ways. One of the most significant differences is that governmental units do not have a strong profit motive. Instead, governmental units are empowered by law to render certain services to citizens and further empowered by law to raise revenues necessary to finance those services. Governmental units tend to adopt service programs that they deem necessary or desirable and then search for revenue sources to support them. For example, a city may increase its sales tax and designate the additional revenue for a new public transportation system. A governmental unit may levy taxes to pay for a service, and, once the tax is established, it may continue even after the need for the service declines. The tax revenues may then become available to support other desired programs. Thus, governmental units often establish a range of services to be rendered that is only indirectly influenced by constraints on revenue. This indirect relationship, plus the fact that the resources and revenues are usually extracted from the populace on an individually involuntary basis, influences the objectives, content, and format of governmental financial reports.

100.12 Another difference between governmental units and business enterprises is that political and social considerations motivate the activities and operating policies of most governmental administrations and elected officials to a significantly greater degree than they affect businesses. As Chapter 3 explains, these considerations can affect the risk of material errors or fraud existing and, thus, the strategy for auditing the financial statements.

100.13 Exhibit 1-1 summarizes various distinctions between the business and governmental sectors relating to management goals and financial accounting, reporting, and auditing. The audit approach and related programs in this *Guide* give due recognition to these different characteristics of governmental objectives, financial statements, and risk factors.

Exhibit 1-1

Distinguishing Characteristics of Governmental and Business Sectors

Factor	Business	Government
Management Goals	Economic (profit) orientation that centers on results of operations and cash flows.	Service orientation and concern for social and political matters. Economic concerns limited to availability of sufficient resources to accomplish service goals.
Primary Financial	Management, investors, and	Citizens, administrators, legislative

Statement Users	creditors.	bodies, creditors, and providers of financial assistance.
Accounting Standards	Relatively large body of principles and standards. Accrual basis.	Relatively smaller body of specific guidance. Accrual basis for the government as a whole and either accrual or modified accrual basis for funds.
Financial Reporting	Statements that present financial position, results of operations, and cash flows.	Statements that demonstrate both fiscal and operational accountability with emphasis on the government's major funds and required budgetary comparison statements or schedules.
Primary Audit Needs	Audits in accordance with GAAS or PCAOB auditing standards.	Audits in accordance with GAAS plus, in many cases, audits in accordance with additional regulatory (governmental) audit standards.

---

[1] The OMB's *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance) significantly changes the requirements for federal award recipients and their auditors. The audit requirements in the Uniform Guidance are effective for audits of fiscal years beginning on or after December 26, 2014. The first audits that should be performed under the Uniform Guidance are for years ending December 31, 2015. The Uniform Guidance is discussed in detail in Chapter 13 and has been fully implemented throughout this *Guide* and related practice aids.

[2] *PPC's Practice Audits for Audits of School Districts* is a new product providing auditors of school districts with audit programs and other practice aids designed specifically for audits of public school districts. These practice aids can be ordered by calling (800) 431-9025 or visiting **tax.thomsonreuters.com**.

END OF DOCUMENT -

101 Authoritative Auditing Literature

Auditing Literature

101.1 Authoritative auditing guidance relevant to governmental units may be found in pronouncements that are general to both governmental and nongovernmental entities and in pronouncements specific to governmental units. The AICPA's Statements on Auditing Standards (SASs) and auditing interpretations and the AICPA *Code of Professional Conduct* are generally applicable to governmental audits. Within this general AICPA literature are some documents specific to governmental units. Specific auditing literature has also been issued by the U.S. Congress, the U.S. Government Accountability Office (GAO), and the Office of Management and Budget (OMB). The hierarchy for application of these pronouncements is discussed beginning at paragraph 102.6. Auditors are encouraged to consult the authoritative literature referenced in this *Guide*. This *Guide* is intended to supplement, not replace, authoritative accounting and auditing guidance.

Generally Accepted Auditing Standards

101.2 Auditors of nonpublic entities, including state and local governments, should conduct their engagements in accordance with GAAS developed by the AICPA. The AICPA *Code of Professional Conduct* requires members to comply with SASs. This *Guide* is updated for changes in professional literature and includes guidance about how those changes might affect audits of local governments. However, even when using the practice aids in this *Guide*, auditors are responsible for awareness and timely implementation of new pronouncements. The authors recommend that firms have a system in place to ensure staff members are informed about current authoritative literature.

101.3 **Defining Professional Responsibility** The auditor's degree of responsibility in complying with professional requirements is identified through two categories as follows (AU-C 200.25):

• *Unconditional Requirements.* Unconditional requirements are those that an auditor must follow in all cases if the circumstances apply to the requirement. Auditing standards use the word *must* to indicate an unconditional requirement.

• *Presumptively Mandatory Requirements.* An auditor must comply with a presumptively mandatory requirement in all cases in which such a requirement is relevant except in rare circumstances when the auditor determines it necessary to depart from a relevant requirement. In that case, the auditor should perform alternative procedures to achieve the intent of the requirement (see AU-C 200.26). Auditing standards use the word *should* to indicate a presumptively mandatory requirement.

The auditor must document the justification for any necessary departure from a presumptively mandatory requirement of

GAAS, along with how alternative procedures performed sufficiently achieve the intent of the requirement.

101.4 **Use of the Terms *Must* and *Should*** Throughout this *Guide*, the authors use the terms *must* and *should* in accordance with AU-C 200.25. The authors also use the term *is required* interchangeably with *should*.

101.5 **Form and Structure of the Auditing Standards** Each auditing standard is divided into the following topics:

- *Introduction.* Includes matters such as the purpose and scope of the guidance, subject matter, effective date, and other introductory material.

- *Objectives.* Establishes objectives that allow the auditor to understand what he or she should achieve under the standards. The auditor uses the objectives to determine whether additional procedures are necessary for their achievement and to evaluate whether sufficient appropriate audit evidence has been obtained.

- *Definitions.* Provides key definitions that are relevant to the standard.

- *Requirements.* States the requirements that the auditor is to follow to achieve the objectives unless the standard is not relevant or the requirement is conditional and the condition does not exist.

- *Application and Other Explanatory Material.* Provides further guidance to the auditor in applying or understanding the requirements. While this material does not in itself impose a requirement, auditors should understand this guidance. How it is applied will depend on professional judgment in the circumstances considering the objectives of the standard. The requirements section references the applicable application and explanatory material. Also, when appropriate, considerations relating to smaller and less complex entities are included in this section.

101.6 A standard may also contain exhibits or appendices. Appendices to a standard are part of the application and other explanatory material. The purpose and intended use of an appendix is explained in the standard or in the title and introduction of the appendix. Exhibits to standards are interpretive publications. Interpretive publications are not auditing standards and do not contain requirements. Rather, they are recommendations on applying the standards in particular circumstances that are issued under the authority of the Auditing Standards Board. Auditors are required to consider applicable interpretive publications when planning and performing the audit.

101.7 **AU-C Section Organization** Within the AICPA *Professional Standards*, the auditing standards use “AU-C” section numbers. The organization of the AU-C sections is as follows:

- Preface.

- Glossary.

- AU-C Section 200-299: General Principles and Responsibilities.

• AU-C Section 300-499: Risk Assessment and Response to Assessed Risks.

• AU-C Section 500-599: Audit Evidence.

• AU-C Section 600-699: Using the Work of Others.

• AU-C Section 700-799: Audit Conclusions and Reporting.

• AU-C Section 800-899: Special Considerations.

• AU-C Section 900-999: Special Considerations in the United States.

• Appendixes.

101.8 **Preface** AU-C Preface, *Principles Underlying an Audit Conducted in Accordance With Generally Accepted Auditing Standards*, contains the principles underlying an audit conducted in accordance with generally accepted auditing standards (the principles). These principles are not requirements and are not authoritative. They provide a framework that is helpful in understanding and explaining an audit and are organized to provide a structure for the codification of SASs. The structure addresses the purpose of an audit, responsibilities of the auditor, performance of the audit, and reporting.

101.9 **Overall Objectives and Requirements** AU-C 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*, contains the auditor's overall responsibilities in accordance with GAAS. The overall objectives of the auditor in conducting an audit of financial statements are as follows:

• Obtain reasonable assurance about whether the financial statements are free from material misstatement.

• In accordance with the auditor's findings, (a) report on the financial statements and (b) make the communications required by GAAS.

101.10 AU-C 200.15 states that the auditor must be independent of the entity when performing an engagement in accordance with GAAS unless (a) GAAS provides otherwise or (b) law or regulation requires accepting the engagement and reporting on the financial statements. Independence requirements are discussed in section 201.

101.11 **AICPA *Code of Professional Conduct*** The AICPA *Code of Professional Conduct* provides guidance and rules that auditors need to comply with in connection with an audit engagement. As noted in AU-C 220.A4, the *Code of Professional Conduct* (Code) sets forth the fundamental principles of professional ethics, including objectivity and independence. As discussed in paragraph 101.10, the auditor is required to be independent when performing an audit in accordance with GAAS. AU-C 200.16 also requires auditors to follow ethical requirements that are relevant to the engagement.

101.12 In May 2014, the AICPA issued a revised *Code of Professional Conduct* (Code). The revised Code was effective on December 15, 2014, with the exception of the two broad conceptual frameworks, one for members in public practice and one for members in business, that had a one year delayed effective date (December 15, 2015). The Code is divided into three parts that separately apply to members in public practice, members in business, and other members (such as retired and unemployed members), as well as a preface that applies to all members. The Code provides a numbering system with the reference preface of "ET." The Code provides conceptual frameworks that sets forth requirements in those situations where the member has identified a threat to compliance with the rules in the Code, and the relationship or circumstance creating the threat is not covered within the Code.

101.13 When applicable, this *Guide* provides references to the numbering system within the Code. Section 201 provides additional discussion of certain independence considerations in connection with client acceptance and continuance.

Quality Control

101.14 **Statement on Quality Control Standards** Statement on Quality Control Standard No. 8, *A Firm's System of Quality Control*, establishes standards and provides guidance for a CPA firm's responsibilities for its system of quality control (QC) for its accounting and auditing practice. SQCS No. 8 comprehensively addresses the quality control processes over a firm's accounting and auditing practice. The standard places an unconditional obligation on the firm to establish a QC system designed to provide reasonable assurance that the firm complies with professional standards and legal and regulatory requirements, and that it issues reports that are appropriate in the circumstances. *PPC's Guide to Quality Control* provides guidance and practice aids to assist firms in developing, implementing, and maintaining a system of quality control.

101.15 **Quality Control Auditing Standard** AU-C 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*, provides requirements and application and other explanatory material to the auditor and engagement partner as they implement each element of quality control during the performance of an audit of financial statements. Thus, for every quality control element discussed in SQCS No. 8, AU-C 220 includes information that conveys how the firm ensures that the requirements of SQCS No. 8 are met in an audit engagement. The responsibility to ensure compliance with AU-C 220 is primarily placed on the audit engagement partner. However, certain requirements are also imposed on the engagement team and, if applicable, engagement quality control reviewer. In meeting the requirements of the quality control auditing standard, the engagement partner is permitted to delegate his or her responsibilities, and the engagement team may rely on the firm's quality control system unless the engagement partner has indicated that it is inappropriate to do so.

101.16 The objective is for the auditor to implement quality control procedures at the engagement level that provide reasonable assurance that—

- The audit has been performed in accordance with professional standards and meets applicable legal and regulatory requirements.

- In the circumstances, the auditor's report issued is appropriate.

101.17 **AICPA Initiative on Enhancing Audit Quality** The AICPA launched an Enhancing Audit Quality initiative in May 2014. This comprehensive effort not only is focused on specific quality issues that have arisen in the audits of private entities but is intended to align the objectives of all AICPA audit-related efforts to improve audit performance. In certain areas, peer reviewers and, where applicable, government oversight agencies, continue to note issues in audit quality. The AICPA has provided examples of matters noted in peer reviews for engagements with year-ends between March 31, 2014, and June 30, 2015, at

www.aicpa.org/InterestAreas/PeerReview/Community/PeerReviewers/DownloadableDocuments/Matters-in-PR.pdf.

101.18 In May 2015, the AICPA issued its *6-Point Plan to Improve Audits* (6-Point Plan), which addresses specific audit quality issues and provides a roadmap to the profession for maintaining and improving audit quality. The 6-Point Plan is in response to feedback received on a paper published in 2014 by the AICPA, *Enhancing Audit Quality, Plans and Perspectives for the U.S. CPA Profession*.

101.19 The AICPA's 6-Point Plan concentrates on financial statement audits of private companies, with a focus on the specialized audits of employee benefit plans and governmental entities. The 6-Point Plan outlines enhancements in support of audit quality in the following areas (with a quick summary of each of those points):

• *Pre-licensure.* Enhancements would update the CPA exam to increase assessment of higher-order skills such as critical thinking and professional skepticism, add high school advanced placement (AP) classes in accounting, and change college-level accounting education.

• *Standards and Ethics.* Proposed changes include quality control standards implementation support, revisions to the auditor's report, codification of the ethics requirements, and evaluation of the implementation of the clarified auditing standards.

• *CPA Learning and Support.* Enhancements would include competency models for audits, competency assessment tools and resources, new certificate programs, and new learning programs.

• *Peer Review.* Enhancements would include an increased peer review focus on higher-risk industries, which include employee benefit plans and Single Audits and more significant remediation plans.

• *Practice Monitoring of the Future.* This long-term initiative focuses on real-time, ongoing monitoring of firm quality checks.

• *Enforcement.* Enforcement focuses on aggressive investigation of referrals of deficiencies and enhanced coordination with state boards of accounting.

101.20 The 6-Point Plan can be obtained on the AICPA's website at **www.aicpa.org/InterestAreas/PeerReview/DownloadableDocuments/EAQ-6-point-plan.PDF**.

101.21 Also in November 2015, the AICPA's Peer Review Board issued an exposure draft to its Standards for Performing and Reporting on Peer Reviews, *Improving Transparency and Effectiveness of Peer Review*, as part of the audit quality initiative. This and other information on the AICPA's Enhancing Audit Quality Initiative can be located on the AICPA's website at **www.aicpa.org/interestareas/peerreview/pages/eaq.aspx.**

101.22 How PPC Guides Contribute to Audit Quality.. If used properly based on the circumstances of the particular engagement, *PPC's Guide to Audits of Local Governments* and its practice aids contribute to performing audits in accordance with professional standards. This *Guide* has been updated for relevant professional standards, and, as noted in the introductory materials, the Tax and Accounting business of Thomson Reuters has voluntarily elected to undergo a peer review on an annual basis of its system for the development and maintenance of quality control materials.

101.23 To help achieve an audit performed in accordance with professional standards, the *Guide* outlines an overall audit process discussed further in section 102. Also, the authors recommend that, in addition to a careful review of the professional standards, the practice aids, where applicable, be applied to the relevant circumstances of audit engagements. Practice aids in the *Guide* typically incorporate relevant professional standards (as well as best practices and practical guidance). As discussed further beginning in paragraph 102.5, if the auditor decides to use other methods to perform and document audit procedures for matters addressed by a practice aid, the authors suggest that the practice aid be carefully reviewed to ensure that relevant requirements are incorporated in the audit procedures and documentation. Also, chapter material in the *Guide* should not be overlooked since it provides important *additional* guidance on professional standards, including other practical information, as well as how the practice aids may be applied to audit engagements. Of course, the auditor needs to apply professional judgement and skepticism, incorporate appropriate competence in the circumstances, and ensure due diligence throughout the audit process. [3]

Specific Auditing Literature

101.24 The following deal specifically with governmental auditing:

- AU-C 935, *Compliance Audits*, address the application of generally accepted auditing standards to a compliance audit, such as a Single Audit.

- Auditing Interpretations 1-3 of AU-C 265 (AU-C 9265.01-.10) provide guidance related to communication of deficiencies in internal control over compliance related to Recovery Act awards that have been identified at an interim date prior to the completion of a Single Audit. (The Interpretations provide illustrative language that may be used whenever the auditor chooses or is required to provide an early written communication of significant deficiencies or material weaknesses in internal control over compliance—not just for Recovery Act awards.)

- Auditing Interpretations 2-3 of AU-C 500 (AU-C 9500.23-.36) provide guidance related to sufficient appropriate audit evidence for audits of governmental employers that participate in cost-sharing or agent multiple-employer pension plans and have implemented GASBS No. 68. (See the discussion beginning in paragraph 904.25.)

- Auditing Interpretations 1-2 of AU-C 805 (AU-C 9805.01-.12) provide guidance related to audit reports for audits of governmental employers that participate in cost-sharing or agent multiple-employer pension plans and have implemented GASBS No. 68. (See the discussion beginning in paragraph 904.25.)

- Auditing Interpretation 1 of AU-C 600 (AU-C 9600.01-.02) provides guidance related to group audits and whether a government employer that has implemented GASBS No. 68 should consider the pension plan a component. (See the discussion beginning in paragraph 904.25.)

- GAO *Government Auditing Standards, 2011 Revision* (the Yellow Book) incorporates GAAS and adds other requirements that together constitute generally accepted government auditing standards. These standards apply to certain audits, including Single Audits, of entities that receive federal, state, or local government financial assistance, or as required by law, such as state law, or contract. A link to the Yellow Book is included in *PPC's Government Documents Library* at GDL Gov. Doc. No. 2. See paragraph 105.14.

- Single Audit Act Amendments of 1996 (Public Law 104-156—The Act) is the federal statute that establishes a legal requirement for state and local governmental units expending stipulated amounts of awards to have an audit meeting specifications in the Act and related regulations. (In this *Guide*, references to the Single Audit Act also encompass the Single Audit Act Amendments of 1996. This is consistent with references in the GAS/SA Audit Guide.) The Act is included in *PPC's Government Documents Library* at GDL Gov. Doc. No. 1. Other government regulatory pronouncements related to the Single Audit are discussed in Chapter 13.

- AICPA Audit and Accounting Guide, *State and Local Governments* (SLG), provides guidance on applying GAAS to audits of governmental financial statements. It also discusses accounting pronouncements and recognized practices that are unique to governments.

- AICPA Audit Guide, *Government Auditing Standards and Single Audits* (GAS/SA Audit Guide), provides guidance on the auditor's responsibilities when performing a Yellow Book audit or a Single Audit under both the OMB Circular A-133 and the Uniform Guidance.

101.25 The AICPA has also issued the following nonauthoritative guidance that deals specifically with governmental auditing:

- AICPA Audit Risk Alert, *State and Local Governmental Developments*, provides nonauthoritative guidance on recent issues and developments affecting audits of governmental entities. (See paragraph 101.27.)

- AICPA Audit Risk Alert, *Government Auditing Standards and Single Audit Developments*, provides nonauthoritative guidance on recent issues and developments affecting Yellow Book audits and Single Audits. (See paragraph 101.33.)

101.26 Generally accepted auditing standards and *Government Auditing Standards* are discussed in more detail in section 105. Audit requirements for Single Audits are discussed in Chapter 13.

Government Audit Risk Alert

101.27 The AICPA Audit Risk Alert, *State and Local Governmental Developments—2015-16*, informs industry professionals of recent industry, economic, regulatory, and legislative developments, as well as audit and accounting issues. Many of the issues covered in the risk alert are addressed throughout this *Guide*. However, the following items are also highlighted here.

101.28 **Economic and Industry Developments** The risk alert focuses first on the impact of the current economic environment on federal, state, and local governments, including the matters discussed in the following paragraphs.

101.29 The real gross domestic product increased 3.7% in the second quarter of 2015, up from 0.6% growth in the first quarter and from an annual growth rate of 1.9% in 2013. The unemployment rate continues to decline with 2.2 million long-term unemployed people in August 2015,, a decrease of 779,000 in the past 12 months.

101.30 January to April 2015 showed an increase in income tax collections of 11.5% (in 38 of the 41 income tax states) over the same time period the previous year. States are expected to increase their general fund spending in 2015 based on adopted budgets. Local property tax revenues are expected to increase, and municipal employment is increasing for the first time since 2008.

101.31 **Audit Issues and Developments** The risk alert discusses audit issues and developments related to pensions. It highlights the new Chapter (13) that was added to SLG to assist with implementation and auditing (GASBS Nos. 67 and 68). Part I of that Chapter discusses the implications of GASBS No. 67 to plan accounting and financial reporting. Part II and III cover GASBS No. 68, single and agent employers, and cost-sharing employers. The Appendixes to SLG Chapter 13 provide guidance on multiple-employer plans and the pension white papers issued by the AICPA's State and Local Government Expert Panel (SLGEP). In addition, the risk alert indicates that the SLGEP published an article on the GAQC website in October 2015 on emerging pension issues.

101.32 **Accounting Issues and Developments** The risk alert discusses recently issued accounting guidance. Recent accounting pronouncements include—

- GASBS No. 72, *Fair Value Measurement and Application*.
- GASBS No. 73, *Accounting and Financial Reporting for Pensions and Related Assets That Are Not within the Scope of GASB Statement 68, and Amendments to Certain Provisions of GASB Statements 67 and 68*.
- GASBS No. 74, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*.
- GASBS No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*.
- GASBS No. 76, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*.
- GASBS No. 77, *Tax Abatement Disclosures*.

Audit Risk Alert for Single Audits

101.33 The AICPA Audit Risk Alert, *Government Auditing Standards and Single Audit Developments—2015/16*, is prepared for auditors of organizations that receive federal awards and is similar to the audit risk alert for state and local governmental developments. The risk alert provides an overview of recent industry, regulatory, and professional developments. Some of the key points are mentioned in the following paragraphs.

101.34 **Legislative and Regulatory Developments** The most significant discussion topics in recent legislative and regulatory developments is the issuance of the *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance). The risk alert includes extensive coverage of the Uniform Guidance with discussions on implementing regulations of federal agencies, technical corrections made to the Uniform Guidance, COFAR FAQs, application of effective dates, and the definitions of the terms *must* and *should* in the Uniform Guidance (which differs from those used in GAAS). Considerations for audits performed under the Uniform Guidance are provided, including planning, materiality, SEFA transition, internal control over compliance, major program determination, low-risk auditees, reporting, and sampling considerations. The 2015 Compliance Supplement is discussed with emphasis on Parts 3.1 and 3.2 and when each part is applicable. Other topics include requirements related to pass-through entities, protected personally identifiable information (PII), and updates concerning the Federal Audit Clearinghouse shutdown and reopening.

101.35 **Audit Developments** The following audit quality and developments are discussed:

- Frameworks for internal control—both COSO's *Internal Control—Integrated Framework* and the GAO's Green Book.

- Single Audit recent peer review findings.

101.36 **Other Matters** The risk alert also discusses the following important developments:

- The Uniform Guidance requirement for the OMB to perform an audit quality study.

- AICPA's ongoing clarity project on the attestation standards.

- Digital Accountability and Transparency Act of 2014, which was signed into law in May 2014.

- OMB's implementation of a pilot program to reduce recipients' reporting burden.

Auditors are encouraged to review these topics to stay abreast of developments that could have a major impact on their audits.

---

[3] *PPC's Guide to Quality Control* provides guidance on a practical, cost-effective approach to designing and implementing an effective quality control system pursuant to the AICPA Statements on Quality Control Standards.

END OF DOCUMENT -

102 Governmental Accounting Standards

Accounting Literature

102.1 Governmental entities are subject to generally accepted accounting principles (GAAP) for state and local governments. The Governmental Accounting Standards Board (GASB) is the official standards setting body for governmental GAAP. The following deal specifically with governmental accounting:

- GASB Statements of Governmental Accounting Standards and Interpretations deal with a variety of accounting and financial reporting issues and are enforceable under ET 1.320.001 of the AICPA's *Code of Professional Conduct*. (See paragraph 102.5.) GASBS No. 1 acknowledges the authoritative status of the GASB Codification. (See the following item and paragraph 102.6.)

- *Codification of Governmental Accounting and Financial Reporting Standards* of the Governmental Accounting Standards Board is an integration of currently effective accounting and reporting standards for state and local governmental units.

- AICPA Audit and Accounting Guide, *State and Local Governments*, discusses existing accounting pronouncements and recognized practices unique to governmental units. It also gives guidance on applying GAAS to audits of state and local governmental financial statements.

The Governmental Accounting Standards Board

102.2 Governmental entities are subject to generally accepted accounting principles (GAAP) for state and local governments. The Governmental Accounting Standards Board (GASB) is recognized by the AICPA as the primary standards setting body for governmental GAAP. The GASB is a seven-member board that operates much like the Financial Accounting Standards Board (FASB) and issues similar types of authoritative pronouncements.

102.3 The GASB's first authoritative pronouncement was GASBS No. 1, *Authoritative Status of NCGA Pronouncements and AICPA Industry Audit Guide*. This Statement recognizes the NCGA Statements and Interpretations and the accounting guidance in the 1974 AICPA Industry Audit Guide on governmental units and related SOPs as being encompassed within GAAP for governmental units. Statement No. 1 continues those standards in force until they are superseded by future GASB pronouncements, and they have been incorporated in the GASB *Codification of Governmental Accounting and Financial Reporting Standards*. The GASB has issued pronouncements that supersede portions of previous authoritative standards. Each GASB Statement indicates what literature it supersedes, if any. Also, the GASB periodically updates the Codification to reflect current standards. The GASB's website address is www.gasb.org.

102.4 **Statements of the Governmental Accounting Standards Board (GASBS)** Exhibit 1-2 lists each statement issued by the GASB as of the date this *Guide* went to press. Certain recent pronouncements are discussed in detail beginning at paragraph 102.10 due to the significance or complexity of the changes related to those pronouncements.

Exhibit 1-2

Statements of the Governmental Accounting Standards Board

GASBS No.	Title	Issue Date/Superseded by
1	Authoritative Status of NCGA Pronouncements and AICPA Industry Audit Guide	July 1984
2	Financial Reporting of Deferred Compensation Plans Adopted under the Provisions of Internal Revenue Code Section 457	Superseded by GASBS No. 32
3	Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements	April 1986
4	Applicability of FASB Statement No. 87, "Employers' Accounting for Pensions," to State and Local Governmental Employers	Superseded by GASBS No. 27
5	Disclosure of Pension Information by Public Employee Retirement Systems and State and Local Governmental Employers	Superseded by GASBS Nos. 25 and 27
6	Accounting and Financial Reporting for Special Assessments	January 1987
7	Advance Refundings Resulting in Defeasance of Debt	March 1987
8	Applicability of FASB Statement No. 93, "Recognition of Depreciation by Not-for-Profit Organizations," to certain State and Local Governmental Entities	Superseded by GASBS No. 35
9	Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities that Use Proprietary Fund Accounting	September 1989
10	Accounting and Financial Reporting for Risk Financing and Related Insurance Issues	November 1989
11	Measurement Focus and Basis of Accounting—Governmental Fund	Superseded by GASBS No. 34

	Operating Statements		
12	Disclosure of Information on Postemployment Benefits Other Than Pension Benefits by State and Local Governmental Employers	May 1990	
13	Accounting for Operating Leases with Scheduled Rent Increases	May 1990	
14	The Financial Reporting Entity	June 1991	
15	Governmental College and University Accounting and Financial Reporting Models	Superseded by GASBS No. 35	
16	Accounting for Compensated Absences	November 1992	
17	Measurement Focus and Basis of Accounting—Governmental Fund Operating Statements: Amendment of the Effective Dates of GASB Statement No. 11 and related Statements (an amendment of GASB Statement Nos. 10, 11, and 13)	June 1993	
18	Accounting for Municipal Solid Waste Landfill Closure and Postclosure Care Costs	August 1993	
19	Governmental College and University Omnibus Statement (an amendment of GASB Statement Nos. 10 and 15)	Superseded by GASBS No. 35	
20	Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting	Superseded by GASBS No. 62	
21	Accounting for Escheat Property	October 1993	
22	Accounting for Taxpayer-Assessed Tax Revenues in Governmental Funds	Superseded by GASBS No. 33	
23	Accounting and Financial Reporting for Refundings of Debt Reported by Proprietary Activities	December 1993	
24	Accounting and Financial Reporting for Certain Grants and Other Financial Assistance	June 1994	
25	Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans	November 1994	
26	Financial Reporting for Postemployment Healthcare Plans Administered by Defined Benefit Pension Plans	Superseded by GASBS No. 43	
27	Accounting for Pensions by State and Local Governmental Employers	November 1994	
28	Accounting and Financial Reporting for Securities Lending Transactions	May 1995	

29	The Use of Not-for-Profit Accounting and Financial Reporting Principles by Governmental Entities	August 1995	
30	Risk Financing Omnibus (an amendment of GASB Statement No. 10)	February 1996	
31	Accounting and Financial Reporting for Certain Investments and for External Investment Pools	March 1997	
32	Accounting and Financial Reporting for Internal Revenue Code Section 457 Deferred Compensation Plans (a rescission of GASB Statement No. 2 and an amendment of GASB Statement No. 31)	October 1997	
33	Accounting and Financial Reporting for Nonexchange Transactions	December 1998	
34	Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments	June 1999	
35	Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities (an amendment of GASB Statement No. 34)	November 1999	
36	Recipient Reporting for Certain Shared Nonexchange Revenues (an amendment of GASB Statement No. 33)	April 2000	
37	Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Omnibus (an amendment of GASB Statement Nos. 21 and 34)	June 2001	
38	Certain Financial Statement Note Disclosures	June 2001	
39	Determining Whether Certain Organizations Are Component Units (an amendment of GASB Statement No. 14)	May 2002	
40	Deposit and Investment Risk Disclosures (an amendment of GASB Statement No. 3)	March 2003	
41	Budgetary Comparison Schedules—Perspective Differences (an amendment of GASB Statement No. 34)	May 2003	
42	Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries	November 2003	

43	Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans	April 2004	
44	Economic Condition Reporting: The Statistical Section (an amendment of NCGA Statement 1)	May 2004	
45	Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions	June 2004	
46	Net Assets Restricted by Enabling Legislation (an amendment of GASB Statement No. 34)	December 2004	
47	Accounting for Termination Benefits	June 2005	
48	Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues	September 2006	
49	Accounting and Financial Reporting for Pollution Remediation Obligations	November 2006	
50	Pension Disclosures (an amendment of GASB Statement Nos. 25 and 27)	May 2007	
51	Accounting and Financial Reporting for Intangible Assets	June 2007	
52	Land and Other Real Estate Held as Investments by Endowments	November 2007	
53	Accounting and Financial Reporting for Derivative Instruments	June 2008	
54	Fund Balance Reporting and Governmental Fund Type Definitions	February 2009	
55	The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments	March 2009	
56	Codification of Accounting and Financial Reporting Guidance Contained in the AICPA Statements on Auditing Standards	March 2009	
57	OPEB Measurements by Agent Employers and Agent Multiple-Employer Plans	December 2009	
58	Accounting and Financial Reporting for Chapter 9 Bankruptcies	December 2009	
59	Financial Instruments Omnibus	June 2010	
60	Accounting and Financial Reporting for Service Concession Arrangements	November 2010	
61	The Financial Reporting Entity: Omnibus, an amendment of GASB Statement Nos. 14 and 34	November 2010	
62	Codification of Accounting and Financial Reporting Guidance	December 2010	

	Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements		
63	Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position	June 2011	
64	Derivative Instruments: Application of Hedge Accounting Termination Provisions—an amendment of GASB Statement No. 53	June 2011	
65	Items Previously Reported as Assets and Liabilities	March 2012	
66	Technical Corrections—2012—an amendment of GASB Statement Nos. 10 and 62	March 2012	
67	Financial Reporting for Pension Plans—an amendment of GASB Statement No. 25	June 2012	
68	Accounting and Financial Reporting for Pensions—an amendment of GASB Statement No. 27	June 2012	
69	Government Combinations and Disposals of Government Operations	January 2013	
70	Accounting and Financial Reporting for Nonexchange Financial Guarantees	April 2013	
71	Pension Transition for Contributions Made Subsequent to the Measurement Date—an amendment of GASB Statement No. 68	November 2013	
72	Fair Value Measurement and Application	February 2015	
73	Accounting and Financial Reporting for Pensions and Related Assets That Are Not within the Scope of GASB Statement 68, and Amendments to Certain Provisions of GASB Statements 67 and 68	June 2015	
74	Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans	June 2015	
75	Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions	June 2015	
76	The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments	June 2015	
77	Tax Abatement Disclosures	August 2015	
78	Pensions Provided through Certain Multiple-Employer Defined Benefit Pension Plans	December 2015	
79	Certain External Investment Pools and	December 2015	

	Pool Participants	
80	Blending Requirements for Certain Component Units	January 2016

102.5 **Authority of GASB Pronouncements** When the GASB was established, it was agreed that the GASB would establish standards for activities and transactions of state and local governmental entities, and the FASB would continue to establish accounting standards for all other entities. The Council of the AICPA designated the GASB as the body with the authority to establish accounting principles for state and local governmental entities in accordance with ET 1.320.001 of the *Code of Professional Conduct*. ET 1.320.001 provides that an auditor should not express an unmodified opinion if the financial statements or other financial data contain a material departure from an accounting principle promulgated by such a body unless, due to unusual circumstances, adherence to the principle would make the statements misleading. (Such departures are uncommon and ought to be undertaken only after extensive research and consideration.) The Council action gave GASB pronouncements an equivalent status to FASB pronouncements.

102.6 **Authority and Hierarchy of GAAP for Governmental Entities** GASBS No. 76 was issued in June 2015 and supersedes GASB No. 55 for periods beginning after June 15, 2015, with early application permitted. GASBS No. 76 establishes the hierarchy of GAAP with the following categories of accounting principles that are generally accepted in descending order of authority:

a. Officially established accounting principles—GASB Statements. GASB Statements and Interpretations are periodically incorporated in the *Codification of Governmental Accounting and Financial Reporting Standards*.

b. GASB Technical Bulletins, GASB Implementation Guides (incorporated periodically into the *Comprehensive Implementation Guide*), and AICPA literature cleared by the GASB. (AICPA literature made applicable to governments contains a specific statement indicating it has been cleared by the GASB.)

102.7 <u>Using Similar Guidance and Prohibited Applications of GAAP</u>. When specific guidance is not available in categories a and b, GASBS No. 76, paragraph 6, states that governments should consider accounting principles for similar transactions or events within those categories and may then consider other nonauthoritative accounting literature. This should not be done, however, when a pronouncement prohibits its application to that particular transaction or event or otherwise indicates that the accounting treatment should not be applied by analogy. For example, GASBS No. 49 prohibits its application to future pollution remediation activities that are required upon retirement of an asset.

102.8 <u>Other Accounting Literature</u>. GASBS No. 76, paragraph 7, describes what was previously known as GAAP hierarchy category c, d, and e. Nonauthoritative accounting literature could be applied when there is no similar guidance. The GASB indicates sources of nonauthoritative accounting literature include:

• GASB Concepts Statements.

• Pronouncements and other literature of the following:

•• FASB,

- •• Federal Accounting Standards Advisory Board (FASAB),
- •• International Public Sector Accounting Standards Board,
- •• International Accounting Standards Board, and
- •• AICPA literature not cleared by the GASB.

- • Widely recognized and prevalent practices in state and local government.
- • Literature published by other professional associations or regulatory agencies.
- • Accounting textbooks, handbooks, and articles.

102.9 The GASB notes that the appropriateness of using nonauthoritative accounting literature depends on its consistency with GASB Concept Statements, the relevance to the specific circumstances, the specificity of its guidance, and the authority of the literature's issuer or author.

Important Recent Pronouncements

102.10 Several important, and generally complex, pronouncements have recently been issued by the GASB. A summary of the pronouncements is provided below with references to more detailed discussions and how the pronouncements have been incorporated in this *Guide*.

102.11 **Reporting by Pension Plans** GASBS No. 67, *Financial Reporting for Pension Plans—an amendment of GASB Statement No. 25*, replaces the requirements of GASBS Nos. 25 and 50 for pension plans administered through trusts or equivalent arrangements that meet certain criteria. GASBS No. 67 was effective for financial statements for fiscal years beginning after June 15, 2013. GASBS No. 67, as amended, is discussed in section 903 and its disclosure requirements are reflected in the disclosure checklist at ALG-CX-13.1.

102.12 GASBS No. 73, *Accounting and Financial Reporting for Pensions and Related Assets That Are Not within the Scope of GASB Statement 68, and Amendments to Certain Provisions of GASB Statements 67 and 68*, supersedes the remaining guidance in GASBS Nos. 25 and 50 related to defined pension plans that are not administered through a trust that meets certain criteria. In addition, it revises required supplementary information in GASBS No. 67 (also see discussion about amendments to GASBS No. 68 in paragraph 102.15). The new guidance is effective for fiscal years beginning after June 15, 2016, while the amendments to GASBS No. 67 are effective for fiscal years beginning after June 15, 2015.

102.13 **Employer Accounting and Reporting for Pensions** GASBS No. 68, *Accounting and Financial Reporting for Pensions—an amendment of GASB Statement No. 27*, replaces the requirements of GASBS Nos. 27 and 50 for pension plans administered through trusts or equivalent arrangements that meet certain criteria. GASBS No. 68 was effective for fiscal years beginning after June 15, 2014. GASBS No. 68, as amended, is discussed in section 903 and is reflected in the audit programs, confirmations, and checklists, including the disclosure checklist at ALG-CX-13.1.

102.14 The GASB amended GASBS No. 68 by issuing GASBS No. 71, *Pension Transition for Contributions Made Subsequent to the Measurement Date—an amendment of GASB Statement No. 68*, which is to be applied simultaneously with GASBS No. 68. At the beginning of the period in which GASBS No. 68 is adopted, it may not be practical for a government to determine the amounts of all deferred inflows of resources and deferred outflows of resources related to pensions. In such circumstances, GASBS No. 71, para. 3, requires the government to recognize a beginning deferred outflow of resources only for any pension contributions it made subsequent to the measurement date of the beginning net pension liability but before the start of the government's fiscal year. No beginning balances for other deferred outflows of resources and deferred inflows of resources related to pensions should be recognized.

102.15 The GASB also amended GASBS No. 68 by issuing GASBS No. 78, *Pensions Provided through Certain Multiple-Employer Defined Benefit Pension Plans*. GASBS No. 78 provides accounting and reporting guidance for employers whose employees are provided defined benefit pensions through certain, narrowly defined, private or federally sponsored multiple-employer plans and are unable to obtain the data required to comply with GASBS No. 68. Instead, this amendment provides those governments accounting and financial reporting requirements for pension liabilities, expense/expenditure, note disclosures, and required supplementary information based on obtainable information. GASBS No. 78 is effective for fiscal years beginning after December 15, 2015, with earlier application permitted. GASBS No. 78 is discussed in more detail in section 903 and disclosure requirements are included in the disclosure checklist at ALG-CX-13.1.

102.16 **Fair Value Measurements** GASBS No. 72, *Fair Value Measurement and Application*, revises the definition of fair value, outlines appropriate measurement approaches and inputs to determine fair value, and establishes measurement principles. In addition, the statement outlines disclosures that are intended to help users understand how the governmental unit has applied the principles of fair value measurement. GASBS No. 72 is effective for financial statements for fiscal years beginning after June 15, 2015, is discussed further in section 901, and is reflected throughout the practice aids, including the disclosure checklist at ALG-CX-13.1.

102.17 **Reporting by OPEB Plans** GASBS No. 74, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, provides accounting and reporting guidance to OPEB plans, replacing the requirements in GASBS Nos. 43 and 57. The new requirements mirror the accounting and reporting for pension plans included in GASBS No. 67. Like the pension standards, the effective date for the plans precedes the employer requirements with GASBS No. 74 being effective for fiscal years beginning after June 15, 2016. GASBS No. 74 is discussed further in section 906, and its disclosure requirements are included in the disclosure checklist at ALG-CX-13.1.

102.18 **Employer Accounting and Reporting for OPEB** GASBS No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*, is the employer's companion guidance for OPEB, replacing the accounting and reporting requirements in GASBS Nos. 45 and 57. Like the revisions in GASBS No. 68, this standard significantly changes and expands the financial accounting and reporting for OPEB, requiring recognition of the net OPEB liability in the government's statement of net position as well as making revisions to disclosures and required supplementary information. GASBS No. 75 is effective for fiscal years beginning after June 15, 2017 (one year after the plans), with earlier application encouraged. GASBS No. 75 is discussed further in section 906, and its disclosure requirements are included in the disclosure checklist at ALG-CX-13.1.

102.19 **GAAP Hierarchy** As discussed in paragraph 102.6, GASBS No. 76, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*, revises the GAAP hierarchy for governmental entities and condenses the levels to two categories of authoritative GAAP. GASBS No. 76 is effective for periods beginning after June 15, 2015. The impact of these changes are reflected throughout this *Guide*.

102.20 **Tax Abatement Disclosures** GASBS No. 77, *Tax Abatement Disclosures*, requires new disclosures about tax abatement agreements and their impact on the governmental unit's financial position. GASBS No. 77 is effective for periods beginning after December 15, 2015. The impact of these changes are reflected throughout this *Guide*, including the disclosure checklist at ALG-CX-13.1.

102.21 **External Investment Pools** GASBS No. 79, *Certain External Investment Pools and Pool Participants*, was issued in response to recent changes in Securities and Exchange Commission's (SEC) Rule 2a7 for money market funds that are effective in 2016. GASBS No. 79 removes the references to SEC Rule 2a7 and establishes a list of criteria similar to current Rule 2a7. In essence, this statement provides external investment pools and their participants with the ability to continue measuring and reporting their investments or position in the pool at amortized cost as they did prior to the effect of the change in Rule 2a7. In addition, the statement requires additional note disclosures for certain external investment pools and for their participants. GASBS No. 79 is effective for fiscal periods beginning after June 15, 2015 (except for certain provisions regarding portfolio quality, custodial credit risk, and shadow pricing, which are effective for periods beginning after December 15, 2015). GASBS No. 79 is discussed in section 901, and disclosure requirements are included in the disclosure checklist at ALG-CX-13.1.

Objectives of Governmental Accounting and Financial Reporting

102.22 The objectives of financial reporting for governmental units differ from those of business enterprises. The main objective of financial reporting for businesses is information about an enterprise's performance provided by measures of earnings. According to GASB Concepts Statement No. 1, the objectives of financial reporting for governmental units are to provide information to enable financial statement users to assess (a) the government's duty to be publicly accountable, (b) the governmental unit's operating results for the period, and (c) the level of services the governmental unit can provide and its ability to meet its obligations as they become due. Specific objectives include providing information to determine whether current year revenues are sufficient to pay for current year services and whether resources were obtained and used in accordance with the budget and other finance-related requirements. These differences in objectives lead to differences in financial measurement and presentation. The matching concept, which is important to accounting and income determination for business enterprises, does not have the same importance to governmental units. Governmental funds tend to emphasize the availability of liquid resources to pay current liabilities because governmental units levy taxes to pay for expected levels of service. For example, because depreciation is an expense that does not require the payment of a liability, including it in a governmental fund's operating statement does not provide useful information in assessing the fund's ability to pay its bills. Thus, the primary measurement focus for reporting governmental activities relates to the flow of current financial resources (cash and claims to cash) rather than the determination of net income.

102.23 As previously mentioned, governmental units are able to obtain resources from the populace on an individually involuntary basis. This means that governmental units typically have a significant stewardship responsibility to their resource providers. To meet that reporting responsibility, governmental units employ a system of budgetary and fund accounting to demonstrate compliance with laws and regulations that govern the expenditure of public resources.

Budgetary Accounting

102.24 Just as businesses do, governmental units use budgets to monitor revenues and control expenditures. However, the budget has much greater significance in the governmental sector. For one thing, most governmental units are required by law to have a budget and, once adopted, the budget usually has the force of law. Also, various aspects of the budget adoption process are usually specified in statutes, constitutional provisions, etc. The budget adoption process is highly political because the budget determines the allocation of resources to various programs. That is, the budget that the legislative authority (e.g., the city council or board of education) adopts determines the degree to which approved programs will be funded. Because the adopted budget is so important, governmental accounting systems and financial reporting are designed to facilitate and demonstrate adherence to the budget. One such means is fund accounting.

The Fund Structure

102.25 GASB Cod. Sec. 1100.102 defines a *fund* as follows:

> . . . a fiscal and accounting entity with a self-balancing set of accounts recording cash and other financial

resources, together with all related liabilities and residual equities or balances, and changes therein, which are segregated for the purpose of carrying on specific activities or attaining certain objectives in accordance with special regulations, restrictions, or limitations.

102.26 GASB Cod. Sec. 1300.101 gives the rationale for using fund accounting. It explains that the diversity of activities reported by governments and the need to show legal compliance makes it necessary for most governments to use several (and often many) separate funds, each reporting their own assets, deferred outflows of resources, liabilities, deferred inflows of resources, and equity. For this reason, from an accounting and reporting standpoint, each government is a combination of a broad variety of funds, each of which functions independently of the other funds and has a separate set of accounts.

102.27 There are several different categories and types of funds. GASB Cod. Sec. 1300.103 lists the following three fund categories, with eleven fund types within those categories:

a. Governmental fund category

    (1) General fund.

    (2) Special revenue funds.

    (3) Capital projects funds.

    (4) Debt service funds.

    (5) Permanent funds.

b. Proprietary fund category

    (1) Enterprise funds.

    (2) Internal service funds.

c. Fiduciary fund category

    (1) Pension (and other employee benefit) trust funds.

(2) Investment trust funds.

(3) Private-purpose trust funds.

(4) Agency funds.

A governmental entity may have more than one fund in a fund type (for example, several special revenue funds), except that it usually has only one general fund. Exhibit 1-3 summarizes the fund categories and fund types and illustrates the types of transactions reported in each. The following paragraphs define these fund categories and fund types. The classification of funds by category and type is significant because different categories use different bases of accounting.

Exhibit 1-3

Governmental Fund Structure, Accounting, and Reporting

FUND CATEGORY	FUND TYPE	DEFINITION	EXAMPLE TRANSACTIONS		MEASUREMENT FOCUS	BASIS OF ACCOUNTING	FINANCIAL STATEMENTS REQUIRED
			REVENUE	EXPENDITURE/EXPENSE			
	General	To account for and report all financial resources not accounted for and reported in another fund.	Sales taxes.	Police salaries.			
	Special Revenue	To account for and report the proceeds of specific revenue sources that are *restricted* or *committed* for specified purposes other than debt service or capital projects.	Gasoline taxes restricted for a specific purpose.	Street and highway maintenance.			
	Capital	To account for and report financial resources	Bond proceeds.	Building construction.	Current financial resources	Modified	Governmental Fund Balance Sheet. Statement of

Governmental	Projects	*restricted*, *committed*, or *assigned* to be used for capital outlays.			flow (revenues and expenditures).	accrual.	Revenues, Expenditures, and Changes in Governmental Fund Balances.
	Debt Service	To account for and report financial resources *restricted*, *committed*, or *assigned* to be used for principal and interest.	Property taxes committed to pay principal and interest.	Bond interest and principal repayment.			
	Permanent	To account for and report resources that are restricted such that the reporting government (or its citizens) is the beneficiary of the earnings on the principal.	Earnings on permanently restricted resources are used to finance expenditures of specific governmental programs, such as cemetery maintenance.				
Proprietary	Enterprise	To account for activities in which a fee is charged to an external user for goods or services, if elected. Required to be used in three circumstances: when an activity is financed with debt that is secured solely by a pledge of the net revenues from fees and charges of the activity; when laws or regulations require that the activity's costs of	Electric utility bills.	Costs of providing electrical service.	Economic resources flow	Accrual.	Statement of Net Position. Statement of Revenues, Expenses,

		providing services be recovered with fees and charges; or when the activity's pricing policies establish fees and charges designed to recover its costs.			(revenues and expenses).		and Changes in Fund Net Position. Statement of Cash Flows.
	Internal Service	To account for the financing of goods or services provided by one department or unit to another department or to other governmental units on a cost reimbursement basis.	Computer time charges.	Expenses of operating data processing center.			
Fiduciary	Pension Trust	Pension and other employee benefit plans administered by a government.	Employer and employee contributions.	Benefits.	Economic resources flow (revenues and expenses).	Accrual (except for recognition of certain liabilities of defined benefit pension plans and certain post-employment healthcare plans).	Statement of Fiduciary Net Position. Statement of Changes in Fiduciary Net Position.
	Investment Trust	External portion of investment pools held by sponsoring government.	Investment income.	Administrative expenses.			
	Private-purpose	To account for trust arrangements under which principal or interest benefit specific individuals, private organizations, or other governments—but not the reporting government.	Trust income (and expense) that benefit individuals, private organizations, or other governments.				

	Agency	Clearing account that holds assets in a trustee capacity.	N/A [a]	N/A [a]			Statement of Fiduciary Net Position.

Notes:

[a] Agency funds do not report revenue or expenditures. For example, an agency fund may collect sales taxes for other governments which are in turn remitted to the appropriate government. Collections which have not been remitted to other governments are reported as assets offset by equal liabilities.

Governmental Category Funds

102.28 Governmental category funds are used to account for the activities one thinks of as typical functions of government. Police and fire protection, road and street construction and repair, and social services are examples of activities that are accounted for in governmental category funds. The common characteristic of these services is that citizens receive them without directly paying for their cost. For example, the police department does not usually charge a fee for coming to the scene of a crime or for the related investigation. Such services are usually thought of as a right of citizenship. Consequently, there is no attempt to match the cost of the service with the revenues that support it when making pricing decisions or performance evaluations as is the case with profit-seeking entities. The primary focus of financial reporting for governmental category funds is on the flow of current financial resources and on the budgets that provide control over the expenditures. Governmental category resources are obtained from various taxes, grants, and assessments. Laws generally place limits on what projects or activities the resources may be used to support. For example, property taxes may be limited to the support of secondary education.

102.29 There are five governmental fund types in the governmental category:

a. The *general fund* accounts for and reports all financial resources except those accounted for and reported in other funds. A governmental unit reports just one general fund.

b. *Special revenue funds* account for and report the proceeds of specific revenue sources that are *restricted* or *committed* for specified purposes other than debt service or capital projects. A special revenue fund should not be reported unless its foundation is one or more specific restricted or committed revenues.

c. *Capital projects funds* account for and report financial resources *restricted*, *committed*, or *assigned* to be expended for capital outlay. For example, a capital project fund would account for the proceeds of bonds sold to provide funds for building schools.

d. *Debt service funds* account for and report financial resources *restricted*, *committed*, or *assigned* to be expended for principal and interest.

e. *Permanent funds* account for and report resources that are restricted to allow the earnings (and not principal) to be used to support the government's programs, such as cemeteries, libraries, parks, or scholarships.

The definitions of the governmental funds are established by GASBS No. 54. (See section 905.)

102.30 **Modified Accrual Basis of Accounting for Governmental Funds** The modified accrual basis of accounting is used for governmental funds because the profit motive is generally absent from the conduct of governmental fund type activities and because of the budgetary restrictions on governmental fund expenditures. Under the modified accrual basis of accounting, the focus is on sources, uses, and balances of fund current financial resources. Thus, balance sheets of governmental fund types report only expendable resources (i.e., resources that are, or will become, available to pay obligations of the governmental unit), related current liabilities, and resulting fund equity. The operating statements present revenues and expenditures; i.e., decreases in net financial resources (not expenses). For example, the repayment of debt is an expenditure but not an expense. Conversely, depreciation is an expense but not an expenditure. In sum, an expenditure is a use of financial resources, and an expense is commonly described as an expired cost. Thus, the acquisition of a capital asset is an expenditure but not an expense. Expenditures, rather than expenses, are reported because the financial reporting objectives of governmental funds relate to demonstrating compliance with spending restrictions and to presenting the results of *financial* operations. Thus, such common expenses as depreciation or bond discount amortization are not reported in governmental funds' operating statements.

102.31 **Revenues** In governmental fund accounting, the term *revenues* means increases in (sources of) fund financial resources other than from interfund transfers and debt issue proceeds. Revenues are recognized in governmental type funds when they become available and measurable. *Available* means that the revenues will be collected during the year or soon enough after year-end to pay liabilities arising from operations of the year just ended. When resources are recorded but the revenue does not meet the availability criterion, a deferred inflow of resources should be reported until the revenue becomes available.

102.32 GASB Cod. Sec. 1600.107 explains that some revenues are assessed and collected in such a manner that they can appropriately be accrued, whereas others cannot. Revenues and deferred inflows of resources that usually can and should be recorded under the modified accrual basis of accounting include property taxes, regularly billed charges for inspection or other routinely provided services, most grants from other governments, interfund transfers and other transactions, and sales and income taxes where taxpayer liability has been established and collectibility is assured or losses can be reasonably estimated. See a further discussion of accounting considerations beginning at paragraph 902.30.

102.33 **Expenditures** Expenditures generally are recognized in governmental funds when the related liabilities are incurred. A governmental unit might incur a long-term liability for a current cost such as pensions or compensated absences. In that case, only the currently payable portion of the long-term liability is reported in a governmental fund; the noncurrent portion is reported as a governmental activity in the government-wide statement of net assets. As a result, the fund's equity is only reduced by the currently payable portion of the liability. Long-term liabilities for payroll-related expenditures are discussed in more detail beginning at paragraph 904.2.

102.34 **Capital Assets** A governmental fund cannot use capital assets to satisfy fund liabilities. Therefore, most noncurrent assets are not reported in governmental funds but are reported as a governmental activity in the government-wide statement of net assets. Similarly, depreciation expense does not represent a use of an expendable resource; thus, depreciation is not recorded on capital assets in the governmental funds financial statements. Capital assets are discussed in more detail beginning at paragraph 905.10.

102.35 **Long-term Debt** Long-term liabilities will be repaid with resources becoming available in future periods. Thus, noncurrent debt is excluded from governmental funds and is reported as a governmental activity in the government-wide statement of net assets. Long-term debt is discussed in more detail beginning at paragraph 905.49.

102.36 **Deferred Outflows of Resources and Deferred Inflows of Resources** Deferred outflows of resources is a financial statement element that represents the consumption of net assets applicable to a future period and are reported in a separate section following assets. Deferred inflows of resources is a financial statement element that represents the acquisition of net assets applicable to a future period and are reported in a separate section following liabilities. Detailed guidance on reporting deferred outflows of resources and deferred inflows of resources in the different categories of funds and in the government-wide statement of net position is provided in section 900.

Proprietary Category Funds

102.37 Proprietary category funds are used to account for and report those activities that are designed to be self-supporting from fees charged to consumers of the funds' goods and services or where the governing body has decided that the periodic determination of revenues, expenses, and net income is appropriate for capital maintenance, public policy, management control, accountability, or other purposes. The accounting and financial reporting practices of proprietary funds are similar to those used for business enterprises and focus on capital maintenance and the flow of economic resources. That is, revenues are matched with expenses, and net income is determined using accrual accounting methods. For example, capital assets are depreciated, and related depreciation expense is allocated over the assets' useful lives. Also, long-term debt is included in proprietary funds statements of net position. In summary, many of the normal financial accounting practices used for business enterprises are used to account for proprietary fund activities.

102.38 As discussed in the previous paragraph, accounting for and presentation of activities and balances of proprietary funds is similar to that of business enterprises as the activities and transactions resulting in proprietary funds are generally exchange transactions in which citizens of a government benefit from goods or services provided by the government in exchange for fees. However, in certain situations, deferred outflows of resources and deferred inflows of resources are to be reported in the statement of net position. Detailed guidance on reporting deferred outflows of resources and deferred inflows of resources in the different categories of funds and in the government-wide statement of net position is provided in section 900.

102.39 Two fund types are included in the proprietary fund category: enterprise and internal service funds.

- *Enterprise funds* may be used to account for any activity in which a fee is charged to an external user for goods or services. However, they must be used to account for activities (a) that are financed with debt that is secured solely by a pledge of the net revenues from fees and charges of the activity, (b) when laws or regulations require that the activity's costs of providing services, including capital costs, such as depreciation or debt service, be recovered with fees and charges (not taxes), or (c) the pricing policies of the activity establish fees and charges designed to recover its costs. Examples of activities conducted by proprietary category funds include water, electric, and gas utilities, hospitals, airports, toll roads and bridges, and harbors. Such operations are financed and operated in a manner similar to private businesses and are intended to be self-supporting through charges to users.

- *Internal service funds* account for the financing of goods or services provided by one governmental department or agency to another on a cost-reimbursement basis. Examples of such operations include computer centers, vehicle pools, and supply centers. As with enterprise funds, internal service funds are expected to be self-supporting through charges to users.

Fiduciary Category Funds

102.40 The fiduciary funds category consists of the following fund types:

- *Pension (and other employee benefit) trust funds* typically account for a government's single-employer public employee retirement plan, other postemployment benefit plan, or other employee benefit plan.

- *Investment trust funds* account for the external portion of a sponsoring governmental unit's investment pool.

- *Private-purpose trust funds* account for trust arrangements under which principal and income benefit individuals, private organizations, or other governments, such as escheat property held in trust for the benefit of individuals or other governments.

- *Agency funds* are clearing accounts used to account for assets held for other funds, governments, or individuals. Examples are a fund to hold property taxes collected by one government on behalf of other governments, a fund to hold employee withholding taxes until they are remitted to the appropriate authorities, and a fund to hold refundable construction performance bonds. Agency funds are custodial in nature; that is, their assets equal their liabilities.

GASB Cod. Sec. 1600 explains that, except for the recognition of some liabilities of defined benefit pension plans and certain postemployment healthcare plans, fiduciary funds are accounted for on the accrual basis of accounting.

102.41 In certain situations, deferred outflows of resources and deferred inflows of resources are to be reported in the fiduciary fund statement of net position. Detailed guidance on reporting deferred outflows of resources and deferred inflows of resources in the different categories of funds and in the government-wide statement of net position is provided in section 900.

Scope of Government-wide Reporting

102.42 The activities of a general-purpose government can be categorized into the following three types of activities:

- *Governmental activities* generally are financed through taxes, intergovernmental revenues, and other nonexchange revenues. Examples include fire and police services. Governmental activities are usually reported in governmental funds and internal service funds in the fund financial statements.

- *Business-type activities* are financed in whole or in part by fees charged to those external parties who use the goods or services. Examples include water sales and golf course green fees. Business-type activities are usually reported in enterprise funds in the fund financial statements.

- *Fiduciary activities* involve holding and managing assets for specific individuals or other external parties in accordance with trust agreements or other custodial arrangements. Examples include the net position of external participants in government-sponsored investment pools and the net position of pension plans and other employee benefit plans, held in trust for a government's employees. Fiduciary activities are reported in trust and agency funds in the fund financial statements.

102.43 In accordance with GASBS No. 34, Paragraph 13, the government-wide statements report only the *governmental activities* and *business-type activities* of the primary government (including blended component units) and any discretely presented component units that report governmental or business-type activities. The government-wide statements *exclude* any *fiduciary activities* or component units that are fiduciary in nature. The government-wide financial statements should be prepared using the economic resources measurement basis and the full accrual basis of accounting.

The Financial Reporting Entity

102.44 In the audit of a governmental unit, a significant consideration is what activities should be included in the financial statements. The question arises because governmental units, including small local ones, frequently conduct some of their activities through, or are otherwise related to, other organizations. For example, a city may own and operate a water utility. The water utility may operate rather independently; for example, it may have a governing body separate from the city's, and it may keep its own set of accounting records. Under GAAP, however, the operating activities, assets, and liabilities of the water utility should be combined with other components to form a governmental financial reporting entity if certain criteria are met.

102.45 GASBS No. 14, as amended by GASBS Nos. 39, 61, and 80 establishes standards for determining which organizations should be included in the financial reporting entity and for reporting the financial information of those organizations.

102.46 **Definition** GASBS No. 14 defines the *governmental financial reporting entity* as being made up of two parts:

- The primary government (PG), such as—
  - A general purpose local government.
  - A special purpose state or local government that has a separately elected governing body, is legally separate, and is fiscally independent of other governments.
- *Component units* (CUs), which are defined as—
  - Units for which the PG is financially accountable.
  - Units that must be included to keep the financial statements from being misleading because of the nature or significance of their relationships with the primary government.

102.47 **Financial Reporting** Financial reporting should present an overview yet allow users to distinguish between the PG and its component units. GASBS No. 14 provides two methods for reporting component units in the financial statements of the reporting entity: discrete presentation and blending. Most component units will be discretely presented rather than blended. Discrete presentation means that data will be presented in one or more separate columns to the right of the PG data columns. Additional information about major component units and nonmajor component units in the aggregate should be presented in either combining statements or in condensed financial statements in the notes.

102.48 For those component units that are so closely related to the PG that they are, in effect, the same as the primary government, GASBS No. 14 requires that the blending method be used. Blending means that the component unit's financial data is reported as though the unit is part of the PG. Each fund of a blended CU should be reported as if it were a fund of the same type of the PG—special revenue funds as special revenue funds, enterprise funds as enterprise funds, and so forth. There is a single exception to this rule. GASBS No. 14, paragraph 54, states that because GAAP allows a government to report only one general fund, the general fund of a blended CU should be reclassified as a special revenue fund. Blended governmental or enterprise funds that meet the definition of a major fund should be reported in a separate column in the appropriate set of fund financial statements.

102.49 Blended Component Units.. GASBS No. 14, paragraph 53, requires blending when one of the following circumstances is met:

a. There is substantively the same governing body for both the PG and the CU—e.g., a school board (the PG) that also serves as the board of a school building authority (the CU)—and one of the following criteria also is met:

(1) there is a financial benefit or burden relationship between the primary government and the component unit, or

(2) the operational responsibility for the component unit rests with the management of the primary government. (The term *management of the primary government* refers to personnel below the level of the governing board, such as a county executive or city manager. The term *operational responsibility* means that the primary government manages the component unit in essentially the same manner as it manages its own programs, activities, agencies, or departments.)

b. A CU provides services entirely (or almost entirely) to the PG or benefits the PG exclusively (or almost exclusively). Examples include a building authority, a computing services entity, a captive self-insurance company, or a benefits administration entity. However, benefits provided by the CU to citizens of the PG (for example, a parking garage) are not considered benefits to the PG.

c. A CU's debt, including leases, is expected to be repaid entirely or almost entirely with the primary government's resources. Repayment generally consists of the PG making a pledge or continuing appropriation to cover debt service, which the CU, in turn, pledges as the primary source or security for repayment of the debt. This criterion applies to CUs that provide services to others as well as to financing entities.

102.50 GASBS No. 80, *Blending Requirements for Certain Component Units, an amendment of GASB Statement No. 14*, which was issued in January 2016, amends GASBS No. 14, paragraph 53, to also require use of the blending method for a component unit that is organized as a not-for-profit corporation in which the primary government is the sole corporate member. GASBS No. 80 is effective for reporting periods beginning after June 15, 2016, with earlier implementation encouraged.

102.51 Discretely Presented Component Units.. All nonfiduciary component units that do not meet the criteria for blending should be reported by discrete presentation in the PG's government-wide financial statements. Discrete presentation requires reporting CU financial data in columns and rows separate from the financial data of the PG. GASBS No. 14, as amended, also requires information about each major discretely presented CU to be provided in the basic financial statements of the reporting entity. GASBS No. 14, paragraph 51, as amended by GASBS No. 61, discusses identifying “major” discretely presented component units. Consideration should be given to a CU's nature and significance in comparison to the PG generally based on any of the following three factors:

a. the services that the component unit provides to the citizenry are such that reporting that activity separately as a major component unit is considered to be essential to users of the financial statements,

b. the component unit has significant transactions with the primary government, or

c. there is a significant financial benefit or burden relationship with the primary government.

Consistent with all other GASB pronouncements, the term “significant” is not defined or illustrated.

102.52 **Notes to the Financial Statements** The notes to the financial statements should be segregated between the information pertaining to the PG (including its blended component units) and its discretely presented CUs. Also, the GAAP disclosures found in the *Codification*, Section 2300, are applicable to PGs and their blended CUs.

102.53 **Other Reporting Relationships** GASBS No. 14 also includes guidance on related organizations, joint ventures, jointly governed organizations, and undivided interests. Additional information on these and other reporting entity topics can be found in *PPC's Guide to Preparing Governmental Financial Statements*.

102.54 **Practice Aid** ALG-CX-1.1.2, “Evaluating Potential Component Units and Reporting under GASBS No. 61,” may be used to assist in determining component units and their correct reporting methods.

GASB Concepts Statements

102.55 The GASB issues Concepts Statements (CSs) to provide a conceptual foundation that can be applied to address financial reporting issues. Concepts Statements do not establish GAAP; however, they can be used to gain a better understanding of the fundamental concepts underlying the GASB's financial reporting standards.

102.56 **Concepts Statement on Service Efforts and Accomplishments** GASBCS No. 2, as amended by GASBCS No. 5, establishes a broad framework that the GASB will use when considering standards for reporting service efforts and accomplishments (SEA). The Statement provides a rationale for the objective of SEA reporting and identifies the reporting elements and the qualitative characteristics that SEA performance information should possess. However, the Statement does not establish any SEA measurement or reporting requirements.

102.57 GASBCS No. 2, as amended, explains that SEA reporting is an important part of general purpose external financial reporting, which focuses on providing information to meet the needs of external users. GASBCS No. 2, as amended, further explains that SEA performance measurement and reporting should occur for services that the governmental unit is responsible for providing, regardless of whether the services are provided by the governmental unit itself or by others, such as volunteers or contractors. The three elements of SEA performance measures and related information provide a framework for understanding and assessing results and are important aspects of SEA reporting. Those three elements are—

a. Measures of service efforts (i.e., the amount of financial and nonfinancial resources that are applied to a service).

b. Measures of service accomplishments (i.e., what was provided and achieved with the resources used).

c. Measures that relate service efforts to service accomplishments (i.e., the relationship of service efforts to service outputs, such as the cost per lane-mile of road maintained; or the relationship of service efforts to service outcomes or results, such as the cost per lane-mile of road maintained in good or excellent condition).

102.58 GASBCS No. 2, as amended, clarifies that it is beyond the scope of the GASB to establish the goals and objectives of state and local government services, develop specific nonfinancial measures or indicators of service performance, or establish benchmarks for service performance.

102.59 The government-wide financial statements provide a basis for reporting SEA. GASB Statement No. 34, Appendix B, paragraph 234, points out that the government-wide financial statements should contribute towards achieving the SEA objectives of operational accountability, economy, and efficiency. Nonfinancial information is not provided in the government-wide financial statements, but a link is provided between the financial statements and SEA reporting.

102.60 **Concepts Statement on Communication Methods** GASBCS No. 3 provides a basis for determining where information should be reported in general purpose external financial reports. GASBCS No. 3 states that certain information is better provided outside the financial statements.

102.61 GASBCS No. 3 lists the following four methods that can be used to communicate information in general purpose external financial reports that include basic financial statements:

- Recognition in the basic financial statements.

- Disclosure in the notes to the basic financial statements.

- Presentation as required supplementary information (RSI).

- Presentation as supplementary information (SI).

102.62 When the GASB deliberates how new GAAP information should be communicated, it will begin by determining whether the information meets the definition and criteria for recognition in the basic financial statements. If the information does not meet those tests, disclosure in the notes to the basic financial statements will be considered next, and so forth. The converse is also true. For example, RSI is not an adequate substitute for communicating information that meets the definition and criteria for communication in the notes to the basic financial statements.

102.63 **Concepts Statement on Elements of Financial Statements.** GASBCS No. 4 establishes definitions for seven elements that are the fundamental components of governmental financial statements. Accounts included in financial statements, such as cash, accounts payable, tax revenues, etc., are reported within the broad categories of elements. The concept of a *resource* is central to the definitions of elements. A *resource* is an item with present capacity to provide services to the government's citizens. Resources can either flow to the government or from the government.

102.64 The elements of a statement of financial position are—

- *Assets.* Assets represent resources with present service capacity that the government presently controls.

- *Deferred Outflows of Resources.* A deferred outflow of resources is a consumption of net assets by the government that is applicable to a future reporting period.

- *Liabilities.* Liabilities represent present obligations to sacrifice resources that the government has little or no discretion to avoid.

- *Deferred Inflows of Resources.* A deferred inflow of resources is an acquisition of net assets by the government that is applicable to a future reporting period.

- *Net Position.* Net position represents the residual of all other elements presented in a statement of financial position. (In this *Guide*, the authors also use the term *equity* to refer to net position.)

102.65 The elements of a resource flows statement (i.e., an operating statement) are—

- *Outflows of Resources.* An outflow of resources is a consumption of net assets by the government that is applicable to the reporting period.

- *Inflows of Resources.* An inflow of resources is an acquisition of net assets by the government that is applicable to the reporting period.

102.66 **Concepts Statement on Measurement of Elements of Financial Statements** GASBCS No. 6 provides a basis for the measurement of certain financial statement elements, focusing on assets and liabilities. GASBCS No. 6 does not establish a basis for measurement of inflows, outflows, or deferred inflows or outflows of resources because those elements relate to, or are derived from, assets and liabilities. Similarly, net position is the residual of the other elements in the statement of net position.

102.67 GASBCS No. 6 defines the term *measurement* as the act or process of determining a value for financial statement elements. It establishes two measurement approaches and four measurement attributes.

102.68 The measurement approach used depends on the point in time an amount is reported for an element. The *initial-transaction-date-based measurement* (initial amount) is the transaction price or amount assigned to an asset or liability at the acquisition date, and includes subsequent modifications that are derived from the amount originally reported, such as depreciation or impairment. The *current-financial-statement-date-based measurement* (remeasured amount) is the amount assigned to an asset or liability when an element is remeasured as of the financial statement date.

102.69 Various measurement attributes may be used when applying a measurement approach, including—

- *Historical cost.* The price paid in acquiring an asset or amount received when incurring a liability during an exchange transaction. Historical cost is an entry price that may only be used for initial amounts.

- *Fair value.* The price that would be received for the sale of an asset or paid for the transfer of a liability at the measurement date. Fair value assumes an orderly transaction between market participants in either the principal or most advantageous market. Fair value is an exit price and may be used for initial amounts or remeasured amounts.

- *Replacement cost.* The price that would be paid for an equivalent asset in an orderly transaction at the measurement date. Replacement cost is an entry price that is typically only appropriate for assets and may be used for initial amounts or remeasured amounts.

• *Settlement amount.* The amount that could be realized for an asset or at which a liability could be liquidated. Settlement amount generally requires a counterparty and involves a market that is not active. This attribute may be used for initial amounts or remeasured amounts.

END OF DOCUMENT -

103 Governmental Financial Statements

103.1 This section summarizes certain GASB financial reporting requirements for governmental entities. *PPC's Guide to Preparing Governmental Financial Statements* contains detailed guidance on preparing financial statements in accordance with GAAP. *PPC's Governmental Financial Statements Illustrations and Trends* provides actual government-wide and fund financial statements, notes, and management discussion and analysis for various types and sizes of governmental units.

103.2 This section provides an overview of the governmental financial reporting model established by GASBS No. 34, as amended. Its minimum reporting requirements are discussed beginning in paragraph 103.3.

Minimum Reporting Requirements

103.3 General purpose governments must present the following basic financial statements and required supplementary information (RSI):

• Management's discussion and analysis (MD&A).

• Basic financial statements—

•• Government-wide financial statements.

•• Fund financial statements.

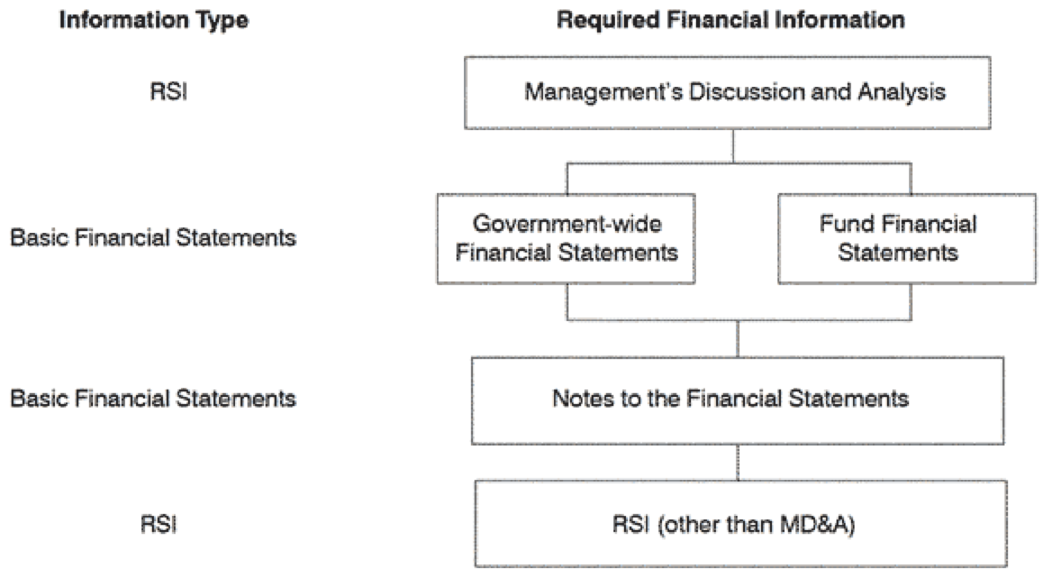
•• Notes to the financial statements.

• RSI, including budgetary comparison schedules, infrastructure condition data, and data required by other GASB pronouncements, if applicable.

The MD&A and RSI, though not part of the basic financial statements, are required for all governments. Exhibit 1-4 illustrates this information graphically. Each of these topics is discussed in the following paragraphs.

Exhibit 1-4

Minimum Financial Reporting Requirements



Management's Discussion and Analysis

103.4 The MD&A is a narrative report prepared in an easy-to-read format by the government's financial manager. It should:

- Introduce the basic financial statements.

- Provide an analytical overview of the government's financial activities for the year based on currently known facts and the financial manager's knowledge of the transactions, events, and conditions reflected in the financial report and the fiscal policies that control the government's operations. Use of charts, tables, and graphs is encouraged.

103.5 **Scope** The narrative should be based on information that management has as of the date of the auditor's report. The focus of the MD&A should be on the primary government, and the analysis should distinguish between information that pertains to the primary government and that of its component units.

103.6 **RSI** The MD&A must be presented as required supplementary information (RSI) *before* the basic financial statements. (Most RSI follows the notes to the financial statements, but an exception was made for the MD&A.) This was done to ensure that the information is presented and that auditors are associated with it at a reasonable cost. Under auditing standards, auditors are required to apply certain limited procedures to RSI even though it is not part of the basic financial statements. In addition, the auditor's report should include an other-matter paragraph that refers to the RSI. See section 1104.

103.7 **Required Components** The information in the MD&A must be confined to the following eight components:

- *A Brief Discussion of the Relationships of the Basic Financial Statements to Each Other and the Major Differences in the Information Provided in Each.* An analysis should be included that will help readers determine whether the measurements and results in fund financial statements provide additional information for analysis or corroborate conclusions drawn from government-wide statements. For example, the discussion should explain why there was a positive change in net position of governmental activities even though the general fund had a significantly different effect in its fund balance at the same time.

• *A Comparison in Condensed Form of Information Presented in the Government-wide Financial Statements for the Current and Prior Year.* The statements must include the information needed to support the following analysis of the government's overall financial position and results of operations addressing certain specified elements.

• *An Analysis of the Government's Overall Financial Position and Results of Operations to Help Users Assess Whether Financial Position Has Improved or Deteriorated Due to Current Year Activities.* The analysis should include reasons for significant changes and important economic factors, such as changes in the tax or employment bases.

• *An Analysis of Balances and Transactions of Individual Funds, Including Any Significant Changes and Any Limitations That Might Affect the Availability of Fund Resources in the Future.*

• *An Analysis of Significant Budget Variances (Original vs. Final Budget and Final Budget vs. Actual Results) for the General Fund or Its Equivalent, Including Reasons for Those Variances That May Affect Future Services or Liquidity.*

• *A Summary of Significant Capital Asset and Long-term Debt Activity with a Discussion of Commitments and Limitations That May Affect Future Financing of Planned Facilities or Services.*

• *A Discussion of Infrastructure Assets (if the Government Has Elected Not to Depreciate Such Assets).* The discussion should include information about the assessed condition of those assets and differences between estimated maintenance costs and actual amounts spent.

• *A Description of Facts, Conditions, or Decisions of Which Management Was Aware on or before the Audit Report Date That Are Expected to Have a Significant Impact on Financial Position or Results of Operations after the Reporting Date.* GASBS No. 56 indicates that it may be necessary to discuss subsequent events or going concern issues.

103.8 **Relationship of MD&A to Transmittal Letter** GASBS No. 34 encourages governments that present a transmittal letter in a CAFR not to duplicate information contained in MD&A. The transmittal letter may focus more on information that is not a required component (such as subjective or prospective information) or elaborate on information in the MD&A.

Government-wide Financial Statements

103.9 The first group of basic financial statements required by GASBS No. 34 is the government-wide financial statements. These statements are comprised of a statement of net position and a statement of activities. The government-wide financial statements must be prepared using the economic resources measurement focus and the accrual basis of accounting. The statements should contain a columnar presentation of governmental activities, business-type activities, and component units. A total column should be presented for the primary government. A total column may be presented for the entity as a whole, but is not required.

103.10 The government-wide financial statements contain significant differences from the fund financial statements. For example—

- The statement of net position and statement of activities focus on the government “taken as a whole” rather than on fund types.

- The statement of net position reports all capital assets, including infrastructure, and the statement of activities reports depreciation expense. However, governments can avoid depreciating infrastructure by (a) using an asset management system with prescribed characteristics and (b) documenting that the assets are being preserved at an established and disclosed condition level. (Governments utilizing this exception must make infrastructure disclosures as RSI. See paragraph 103.16.)

- Capital outlays for governmental activities are reported as capital assets rather than expenditures. Long-term debt proceeds and principal payments are reported as long-term liabilities rather than as other financing sources and expenditures.

- Net position is classified in the following three categories—net investment in capital assets, restricted, and unrestricted. (Restricted net position should distinguish between major types of restrictions.)

- The statement of activities measures “net (expense) revenue” for each of the government's functions and reports revenues by function/program, with general revenues (such as taxes) reported separately. The level of detail of the government-wide statements is at least the same level as that used for the fund financial statements.

- Fiduciary activities are excluded from the government-wide statements because those resources are not available to finance the government's programs.

- Most interfund balances and activities are reclassified and eliminated.

103.11 Since the governmental fund financial statements are reported on the modified accrual basis of accounting, most governments only record the accruals as adjusting entries when preparing the government-wide financial statements. Those adjustments change the results of operations for governmental activities and significantly decrease net position when including such items as compensated absences and other long-term operating liabilities as expenses. However, adjustments for currently deferred receivables (that are deferred due to the availability criterion) or revenues and capital assets result in an increase in net position.

Fund Financial Statements

103.12 Fund financial statements are presented by fund category with the reporting emphasis on individual major funds. Exhibit 1-3 lists the required financial statements, measurement focus, and basis of accounting for each fund category.

The following items should be considered when preparing the fund financial statements:

- Separate columns are required for the general fund and other *major* governmental and enterprise funds. Major funds are those whose revenues, expenditures/expenses, assets and deferred outflows of resources, or liabilities and deferred inflows of resources are at least 10% of corresponding totals for all governmental *or* all enterprise funds and for that same element are at least 5% of the combined totals of the governmental and enterprise funds. In addition, any other fund that government officials feel has importance to financial statement users may be reported as a major fund. Nonmajor funds are reported in the aggregate in a separate column. Major fund reporting does not apply to internal service or fiduciary funds. Proprietary fund statements should report internal service funds in the aggregate in a separate column. Fiduciary fund statements report by fund type and should include discretely presented component units that are fiduciary in nature.

- A summary reconciliation to the government-wide financial statements has to be presented at the bottom of the fund financial statements or in an accompanying schedule. This is necessary since different measurement focuses are used in the statements. Common reconciling items will include capital assets and long-term liabilities.

- Governmental fund balances have to be classified as nonspendable, restricted, committed, assigned, or unassigned. Proprietary fund net position has to be classified as net investment in capital assets, restricted, and unrestricted.

- Proprietary funds must use the direct method for cash flows statements.

Notes to the Financial Statements

103.13 GASBS No. 34 indicates the notes to the financial statements should focus on the primary government (that is, the governmental activities, business-type activities, major funds, and nonmajor funds in the aggregate). In addition, GASBS No. 34 addresses specific disclosures that include—

- A summary of significant accounting policies based on the requirements of the Statement.

- Information about capital assets and long-term liabilities (including separate disclosure of capital assets not being depreciated).

- Information about donor-restricted endowments.

- Segment information for enterprise funds.

103.14 Several other GASB Statements establish requirements for specific note disclosures, some of which are quite complex. Those disclosures are discussed where relevant throughout this *Guide*.

103.15 The authors have developed financial statement disclosure checklists for governmental entities at ALG-CX-13. ALG-CX-13.1 is for general purpose governments. ALG-CX-13.2 and ALG-CX-13.3 are for external investment pools and public entity risk pools, respectively.

Required Supplementary Information (RSI)

103.16 RSI, except the MD&A, should be presented immediately after the notes to the financial statements. In addition to MD&A, RSI includes—

- Supplementary information required under GASBS Nos. 10, 25, 27, 34,43, 45, 50, 67, 68, 73, 74, 75, and 78. [4]

- Budgetary comparison schedules for the general fund and each major special revenue fund with a legally adopted budget (unless the government elects to include the required information in a budgetary comparison *statement* as part of the basic financial statements, rather than as RSI). [5]

- Schedules and accompanying disclosures of infrastructure assets (only if a government elects to use the modified approach and not to depreciate such assets).

The budgetary comparison schedule must include the original and final budget amounts, as well as actual amounts. Though encouraged, a column with variance calculations between actual and either budget amounts is not required.

Separate Financial Statements of a Primary Government

103.17 A primary government may need to issue separate financial statements that do not include the financial data of its component units to satisfy specific legal requirements or for other reasons. Those statements generally follow all relevant presentation aspects of the basic financial statements. GASBS No. 14, however, requires that separate statements of the primary government must acknowledge that they do not include the data of the component units necessary for reporting in conformity with GAAP. Chapter 11 presents an example auditor's report for reporting on the separate financial statements of a primary government in Appendix 11A.

Separate Financial Statements of a Component Unit

103.18 The definition and display provisions of GASBS No. 14 should be applied to separate financial statements of a component unit as if they were the statements of the primary government. Such statements should acknowledge that the component unit is part of another government; for example, Parr County Housing Authority, a component unit of Parr County. Also, the notes to the financial statements should identify the primary government and describe the relationship of the component unit to the primary government.

Financial Statements of an Individual Fund, Agency, or Department

103.19 Many governments choose to or are required to issue separate GAAP-based financial statements for their individual funds, agencies, or departments—reporting units that are less than governments because they have no separate legal standing. Such statements should identify the primary government and disclose the limited reporting objective. GASBS No. 34 addresses the minimum requirements for GAAP financial reports issued by state and local governments. All general and special purpose governments must include a minimum of MD&A, basic financial statements, notes to the financial statements, and other RSI in their GAAP financial reports. The GASB does not address the required content of reports of individual funds, departments, or agencies. However, the AICPA has taken the position that all of the minimum required components must be present for the auditor to issue an opinion that the fund, departmental, or agency financial report is presented fairly in accordance with GAAP. [6] Reports on financial statements of individual funds, agencies, or departments are discussed beginning at paragraph 1101.13.

Comprehensive Annual Financial Report

103.20 GASB Cod. Sec. 2200.101 recommends that governmental units issue a comprehensive annual financial report (CAFR) as the official annual report. A CAFR includes (a) basic financial statements, (b) management's discussion and analysis and other required supplementary information and (c) combining and individual fund statements. The CAFR also includes introductory information, schedules, and statistical data. The auditor's responsibility for information accompanying the basic financial statements and required supplementary information in a CAFR will vary according to the terms of the particular engagement.

---

[4] See further discussion of GASBS Nos. 73, 74, 75, and 78 and their effective dates in Chapter 9.

[5] A government may choose to present budgetary comparison information for funds other than the general fund or special revenue funds with a legally adopted budget; however, that information must be presented and reported on as supplementary information and may not be included as part of the basic financial statements.

[6] According to SLG, Paragraph 15.87, the AICPA position is based on practice history of applying all relevant GAAP to those presentations. AICPA Industry Audit and Accounting Guides specifically made applicable to state and local governments and cleared by the GASB are included in level “b” of the GAAP hierarchy. Principal among these is SLG. However, while the guidance in SLG normally constitutes level “b” GAAP, the GASB did not clear the guidance in SLG paragraph 15.87, and it is not included in the SLG, Appendix B list of level “b” GAAP.

END OF DOCUMENT -

104 Financial Statements Prepared in Accordance with a Special Purpose Framework

104.1 As in the commercial sector, a governmental unit might want or need to issue financial statements prepared in accordance with a special purpose framework, that is, a basis of accounting other than GAAP. For instance, a statute might prescribe a basis of accounting that demonstrates compliance with the cash basis and budget laws.

104.2 AU-C 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*, provides requirements relevant to auditing financial statements prepared in accordance with a special purpose framework as well as limited guidance on presentation of such statements. Typically, if a governmental entity presents non-GAAP financial statements, they are either the cash or regulatory basis. However, AU-C 800.07 identifies all of the following as being special purpose frameworks:

- *Cash Basis:* A basis of accounting that an entity uses to record cash receipts and disbursements. (The cash basis of accounting includes modifications having substantial support, such as recording depreciation on capital assets. Thus, an entity might present financial statements using a pure cash basis or a modified cash basis.)

- *Regulatory Basis:* A basis of accounting that an entity uses to comply with the requirements or financial reporting provisions of a regulatory agency to whose jurisdiction it is subject.

- *Tax basis:* A basis of accounting that an entity uses to file its tax return for the period covered by the financial statements. (SLG, Paragraph 16.01, indicates that the tax basis would not be applicable to governmental financial statements.)

- *Contractual basis:* A basis of accounting that an entity uses to comply with an agreement between the entity and one or more third parties other than the auditor.

- *Other basis:* A basis of accounting that utilizes a definite set of logical, reasonable criteria that is applied to all material items appearing in financial statements.

Except for the contractual basis, these non-GAAP bases of accounting are sometimes referred to as OCBOA.

Presentation and Disclosure Requirements

104.3 Generally, special purpose financial statements should follow relevant GAAP presentation and disclosure requirements and be accompanied by MD&A and other applicable supplementary information, such as budgetary comparison schedules for the general fund and major special revenue funds. When such information accompanies special purpose financial statements, it is referred to as *other information* or *supplementary information*, not as *required supplementary information*.

104.4 Special purpose financial statements should be appropriately titled to indicate the basis of accounting used. The financial statements should include a summary of significant accounting policies and adequately describe how the basis of the presentation differs from GAAP; however, the differences do not have to be quantified.

104.5 AU-C 800.A19-.23 and .A34 provide the following presentation guidance:

- The discussion of the basis of presentation and how the basis differs from GAAP, which is required by AU-C 800.15, ordinarily only describes the primary differences from GAAP. The differences from GAAP do not have to be quantified. (AU-C 800.A18)

- When the financial statements contain items the same as, or similar to, those in financial statements prepared in accordance with GAAP, similar informative disclosures are appropriate. For example, disclosures for depreciation and long-term debt should be comparable to those in financial statements prepared in accordance with GAAP. The financial statements may either provide the relevant disclosure or provide information that communicates the substance of that disclosure. For example, the notes to the financial statements may disclose the repayment terms of long-term debt in a way that communicates information about future principal payments but does not provide the summary of payments for each of the next five years and in five-year increments thereafter that would be needed in a GAAP presentation. (AU-C 800.A21)

- If GAAP would require disclosures of other matters, those same disclosures or disclosures that communicate the substance of those requirements should be made to the extent they are relevant to the basis of accounting. For example, going concern considerations are relevant to cash, modified cash, and regulatory basis presentations and should be disclosed if necessary, but information about the use of estimates is not relevant in a presentation of cash receipts and disbursements that has no estimates. (AU-C 800.17, .A21, and .A34)

- Special purpose financial statements also should include other applicable disclosures that are necessary to achieve fair presentation, such as those for subsequent events, related party transactions, and significant uncertainties. (AU-C 800.A22)

- GAAP disclosure requirements that are not relevant need not be considered. (AU-C 800.A34)

- If GAAP provides requirements for the *presentation* of financial statements, special purpose financial statements should either comply with those requirements or provide information that communicates the substance of those requirements. (AU-C 800.A34)

- A statement of cash flows might not be included in special purpose financial statements. However, if a presentation of cash receipts and disbursements is presented in a format similar to a statement of cash flows or if the government chooses to present such a statement, it should either conform to the requirements for a GAAP presentation or communicate the substance of the GAAP requirements. (AU-C 800.A34)

104.6 According to SLG, Paragraph 16.02, special purpose financial statements may not omit a basic financial statement that is required by GAAP or substitute similar information for a required statement. Instead, substantially similar information may be presented within a required financial statement. For example, GAAP generally requires presentation of government-wide financial statements, inclusion of columns for major funds in the fund financial statements, and separate identification of special and extraordinary items. Special purpose financial statements should include similar government-wide financial statements and a columnar presentation of major funds. However, special and extraordinary items could be disclosed in a note instead of being presented on the face of the financial statements.

104.7 AU-C 800.08 states that the requirements of the applicable financial reporting framework determine the form and content of the financial statements and what represents a complete set of financial statements. According to SLG, Paragraph 16.04, the requirements regarding presentation of a complete set of financial statements do not apply to special purpose financial statements where contractual agreements or regulatory requirements direct presentation of less than a complete set of financial statements. Such financial statements are not required to include all of the basic financial statements required by GAAP. For example, a regulatory provision may require presenting a schedule of cash receipts and disbursements by fund only. That regulatory basis presentation is not intended to present financial position. The lack of a schedule of cash is not a deficiency, nor is the presentation deficient because it lacks other GAAP-required basic financial statements.

Audit Considerations

104.8 As discussed in section 201, AU-C 210 establishes certain preconditions for an audit, including determining the acceptability of the financial reporting framework. In addition to these requirements, AU-C 800 states that the auditor should obtain an understanding of (a) the purpose for which special purpose financial statements are prepared, (b) the intended users of the financial statements, and (c) the steps taken by management to determine that the applicable special purpose financial reporting framework is acceptable in the circumstances.

104.9 According to SLG, Paragraph 16.11, when special purpose financial statements are prepared in accordance with a contractual basis of accounting, the auditor should obtain an understanding of any significant interpretations of the contract that resulted in financial information being materially different from information that would have been presented if management had used another reasonable interpretation.

104.10 AU-C 800 also requires the auditor to evaluate whether special purpose financial statements are suitably titled, include a summary of significant accounting policies, and adequately describe differences between the special purpose framework and GAAP. Specifically, AU-C 800.17 states that when special purpose financial statements include items that are the same as or similar to those in GAAP financial statements, the auditor should evaluate whether the financial statements include informative disclosures similar to those required by GAAP. The auditor also should evaluate whether additional disclosures, beyond those specifically required by the framework, that are related to matters not specifically identified on the face of the financial statements, or other disclosures, are necessary for the financial statements to achieve fair presentation.

104.11 AU-C 800.18-.23 provides requirements for the auditor's report on special purpose financial statements, including requirements specific to regulatory basis financial statements. Section 1103 provides a detailed discussion of auditors' reports on financial statements prepared using a special purpose framework.

104.12 **The Auditor's Consideration of Opinion Units for Special Purpose Financial Statements** For special purpose financial statements, the auditor generally considers opinion units as they would be considered in an audit of GAAP-basis financial statements. Generally, the opinion unit concept requires the auditor to plan, perform, evaluate the results, and report based on governmental activities, business-type activities, aggregate discretely presented component units, each major governmental and enterprise fund, and aggregate remaining fund information (i.e., opinion units).

104.13 SLG, Paragraph 16.13, addresses reporting on special purpose financial statements where contractual provisions or regulatory agreements direct the presentation. In such presentations the opinion unit concept may not apply. For example, the contractual party or regulator may require that the auditor determine materiality and express an opinion on the financial statements as a whole. In such cases, the auditor should look to guidance from the regulatory agency or contract for determining materiality and the opinion units on which to report. If no guidance is provided, the auditor may use professional judgment in applying the opinion unit concept. In that situation, the auditor should consider disaggregations (such as columnar disaggregations) of the presentation (and perhaps certain aggregations of those presentations that represent remaining fund information) to be separate opinion units.

END OF DOCUMENT -

105 Auditing Requirements for Governments

105.1 As discussed in paragraph 100.1, the auditor may need to follow three types of interrelated auditing requirements when auditing a governmental entity:

• AICPA generally accepted auditing standards (GAAS).

• *Government Auditing Standards* issued by the Comptroller General of the United States (the Yellow Book).

• The Single Audit Act and Office of Management and Budget's (OMB) *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance) (also referred to as Single Audits). [7]

105.2 Governmental units have audits of their financial statements for a variety of reasons. Local or state laws may require an audit of the governmental unit's financial statements, a granting agency providing funds to the governmental unit may require an audit of the expenditure of those funds, and lenders or financial intermediaries in a bond issue may recommend or require an audit of the governmental issuer's financial statements. The Single Audit Act requires governmental units that expend stipulated amounts of federal awards to undergo an audit of their financial statements. (The law also requires a study and evaluation of internal control and compliance with laws and regulations relevant to major federal award programs.)

Types of Audits

105.3 **GAAS Audit** Auditors of governmental entities should conduct their engagements in accordance with the AICPA's generally accepted auditing standards. Section 101 of this *Guide* discusses those standards.

105.4 **Financial Audit—*Government Auditing Standards*** Financial audits provide an independent assessment of whether an entity's reported financial information (e.g., financial condition, results, and use of resources) are presented fairly in accordance with an applicable financial reporting framework. Financial audits performed in accordance with *Government Auditing Standards* include financial statement audits and other related financial audits.

105.5 The primary purpose of a financial statement audit is to provide an opinion (or disclaimer of an opinion) about whether the financial statements are presented fairly in all material respects in conformity with GAAP or with a special purpose framework. Other types of financial audits under *Government Auditing Standards* provide for different levels of assurance and encompass various scopes of work, including: (a) providing an opinion on single financial statements, specified elements, accounts, or items of a financial statement; (b) issuing letters for underwriters and certain other parties; and (c) auditing compliance with applicable compliance requirements relating to one or more government programs.

105.6 The Yellow Book incorporates GAAS. Thus, performing a financial audit requires auditing the financial statements in accordance with GAAS, as well as following the additional general, performance, and reporting standards in *Government Auditing Standards*. This includes reporting on internal control over financial reporting and compliance and other matters. An audit of financial statements in accordance with the Yellow Book also includes other reporting and documentation responsibilities, as discussed in more detail where relevant throughout this *Guide*.

105.7 **Compliance Audits** AU-C 935, *Compliance Audits*, address the application of GAAS to a compliance audit, such as a Single Audit. AU-C 935 applies when an auditor is engaged, or required by law or regulation, to perform a compliance audit in accordance with all of the following:

- Generally accepted auditing standards;

- *Government Auditing Standards* requirements for financial audits; and

- A governmental audit requirement that requires an opinion on compliance.

AU-C 935 provides guidance on applying GAAS in a compliance audit. Although a compliance audit is usually performed in conjunction with a financial statement audit, AU-C 935 does not apply to the audit of the financial statements. AU-C 935 is discussed in section 1301.

105.8 **Program Compliance Audit** Federal program grant agreements may require grant recipients to obtain program compliance audits. In program compliance audits, auditors express opinions on (a) the recipient's compliance with the provisions of particular federal grant program agreements and (b) the governmental unit's eligibility for federal funds under those programs. Standards for specific program or grant audits would be found in federal audit guides related to the specific programs.

105.9 **Single Audit** The Single Audit Act requires state and local governmental units expending certain amounts of federal awards to obtain an independent "Single Audit" of all federal funds expended under major federal programs. Such an audit replaces separate audits of individual grants to which the entities would otherwise have been subject under federal requirements. A Single Audit consists of (a) a financial audit performed in accordance with *Government Auditing Standards*, (b) a study and evaluation of the governmental unit's internal control over federal awards programs, and (c) tests of the governmental unit's compliance with federal statutes, regulations, and the terms and conditions of federal awards that could have a direct and material effect on each major program. The Single Audit Act's internal control and federal program compliance requirements exceed minimum requirements under GAAS and the Yellow Book. (See paragraphs 105.13 and 105.43.) Chapter 13 of this *Guide* discusses Single Audits.

Generally Accepted Auditing Standards

105.10 This *Guide* is primarily devoted to the application of GAAS in the audit of a governmental unit's financial statements. To apply GAAS, the auditor follows the guidance and requirements in the SASs, related auditing interpretations, and audit and accounting guides (SLG, GAS/SA Audit Guide, and other applicable AICPA guides).

105.11 **AICPA Fieldwork Standards** AU-C Preface, *Principles Underlying an Audit Conducted in Accordance With Generally Accepted Auditing Standards*, contains the principles underlying an audit conducted in accordance with GAAS. These principles are not requirements and are not authoritative. Rather, they provide a framework that is helpful in understanding and explaining an audit and are organized to provide a structure for the codification of SASs. The preface explains that to obtain the reasonable assurance needed to express an opinion on the financial statements, the auditor does the following:

- Plans the work and properly supervises assistants.

- Determines and applies appropriate materiality levels throughout the audit.

- Identifies and assesses risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, including its internal control.

- Obtains sufficient appropriate audit evidence about whether material misstatements exist by designing and implementing appropriate responses to assessed risks.

The application of these activities is discussed in more detail where relevant throughout this *Guide*.

105.12 **GAAS Requirements Related to Compliance with Laws and Regulations** In the audit of a governmental entity, substantial attention is paid to compliance with laws and regulations. Although management is responsible for ensuring that the entity complies with laws and regulations applicable to its activities, the auditor is responsible, in a GAAS audit, for considering not only laws and regulations, but also provisions of contracts and grant agreements and how they affect the audit. Thus, the auditor is responsible for obtaining reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws, regulations, contracts, and grant agreements that have a material effect on the financial statements.

Government Auditing Standards

105.13 Financial audits under the GAO's *Government Auditing Standards* incorporate GAAS and add requirements that extend beyond GAAS. *Government Auditing Standards* describe ethical principles that are the foundation of governmental audits and establish requirements for the scope of audit work, auditor qualifications and independence, competence of the audit staff, exercise of professional judgment, and quality control and external peer reviews, as well as standards for planning, supervision, and reporting. For example, some of the additional requirements extend beyond GAAS in the following ways:

- More extensive documentation requirements related to independence than the AICPA independence standards. In addition, the Yellow Book conceptual framework for independence is used more frequently than the AICPA's conceptual framework. (See section 201.)

- More restrictive continuing education requirements than the AICPA requirements. (See paragraph 105.28.)

- More requirements relating to communication during the planning stage of the audit. (See paragraph 105.32.)

- An unconditional requirement that auditors must use professional judgment in planning, performing, and reporting on audits and attestation engagements. (See paragraph 105.33.)

- More requirements for considering the results of previous audits and attestation engagements. (See paragraph 301.20.)

- More extensive reporting requirements, which include planning and performing procedures to develop the elements of the findings that are relevant and necessary to achieve the audit objectives. (See paragraph 105.38.)

- More extensive quality control and assurance requirements. (See paragraph 105.39.)

- Additional considerations relating to audit documentation. Discussed throughout this *Guide* where relevant.

105.14 Note that many of these additional standards relate more to reporting than to audit procedures for the audit of the financial statements. That is, many of the standards of fieldwork under GAAS and the Yellow Book are essentially the same. A link to the Yellow Book is included in *PPC's Government Documents Library* at Gov. Doc. No. 2. The Yellow Book is also available on the GAO's website at **www.gao.gov**.

105.15 **General Standards** Chapter 3 of the Yellow Book establishes the general standards applicable when an audit is conducted in accordance with *Government Auditing Standards*. Along with the overarching ethical principles in Chapter 1, the general standards establish a foundation for the credibility of auditors' work. These standards are as follows:

- In all matters relating to the audit work, the audit organization and the individual auditor, whether government or public, must be independent (independence standard). (See paragraph 105.25 and section 201.)

- Auditors must use professional judgment in planning and performing audits and in reporting the results (professional judgment standard). (See paragraph 105.33.)

- The staff assigned to perform the audit must collectively possess adequate professional competence needed to address the audit objectives and perform the work in accordance with *Government Auditing Standards* (competence standard). (See paragraph 105.26 and section 201.)

- Each audit organization performing audits in accordance with *Government Auditing Standards* must (a) establish and maintain a system of quality control that is designed to provide the audit organization with reasonable assurance that the organization and its personnel comply with professional standards and applicable legal and regulatory requirements, and (b) have an external peer review performed by reviewers independent of the audit organization being reviewed at least once every three years (quality control and assurance standard). (See paragraph 105.39.)

105.16 **When Do *Government Auditing Standards* Apply?** A Yellow Book audit can be required by law, regulation, agreement, contract, or policy. The most common Yellow Book audits are those required for federal awards subject to the Single Audit Act Amendments of 1996. In many instances, state laws or state funding agencies may require an audit in accordance with the Yellow Book, regardless of the amount of federal awards expended, if any.

105.17 **The Yellow Book's Ethical Principles** The Yellow Book, in Chapter 1, discusses the fundamental ethical principles that are the foundation for all work performed under *Government Auditing Standards*. Chapter 3 builds on the principles and establishes requirements related to independence, professional judgment, competence, quality control and assurance, and peer reviews.

105.18 The Yellow Book emphasizes that the public expects auditors to follow ethical principles when performing work under *Government Auditing Standards*. According to Paragraph 1.12 of the Yellow Book:

> Ethical principles apply in preserving auditor independence, taking on only work that the audit organization is competent to perform, performing high-quality work, and following the applicable standards cited in the auditors' report.

105.19 Although the Yellow Book's ethical principles are fundamental to all work performed under *Government Auditing Standards*, they are not written as specific requirements. Instead, they provide a framework that enables auditors to consider the facts and circumstances of each situation.

105.20 The Public Interest. The Yellow Book at Paragraph 1.15 defines public interest as "the collective well-being of the community of people and entities the auditors serve." The auditor's acceptance of responsibility to serve the public interest is considered to be critical to auditing in the government environment.

105.21 Integrity. The Yellow Book at Paragraph 1.17 indicates that integrity includes conducting work "with an attitude that is objective, fact-based, nonpartisan, and nonideological with regard to audited entities and users of the auditors' reports." Integrity also includes being "honest, candid, and constructive."

105.22 Objectivity. The Yellow Book at Paragraph 1.19 indicates that objectivity includes being independent in "mind and appearance . . . maintaining an attitude of impartiality, having intellectual honesty, and being free of conflicts of interest." Maintaining objectivity includes continually assessing relationships with audited entities and other stakeholders. (Independence is discussed in more detail beginning in paragraph 105.25 and in section 201.)

105.23 Proper Use of Government Information, Resources, and Positions. The Yellow Book at Paragraph 1.20 emphasizes that government information, resources, and positions are to be used for official purposes. They are not to be used for personal gain or contrary to the interests of the audited entity or the audit organization. The concept of proper use includes proper handling of sensitive or classified information or resources.

105.24 Professional Behavior. The Yellow Book at Paragraph 1.24 emphasizes that expectations for professional behavior include compliance with legal, regulatory, and professional obligations; avoidance of conduct that might discredit the auditor's work; and "putting forth an honest effort in performance of . . . duties and professional services in accordance with the relevant technical and professional standards."

105.25 **Yellow Book Independence Requirements.** *Government Auditing Standards* states that in all matters relating to the audit work, the audit organization and individual auditor, whether government or public, must be independent. If independence is impaired, the auditor should decline to perform a prospective audit or should terminate one that is in progress. The Yellow Book establishes a conceptual framework that should be used to identify, evaluate, and apply safeguards to address threats to independence. The Yellow Book also identifies specific nonaudit services that always impair independence and that auditors are prohibited from providing to audited entities. If a nonaudit service is not specifically prohibited, the auditor is required to assess its impact on independence using the conceptual framework. The Yellow Book independence requirements are discussed in section 201.

105.26 **Yellow Book Competence and Continuing Education Requirements.** The general standard related to competence in the Yellow Book requires that the staff assigned to perform the audit engagement must collectively possess adequate professional competence needed to address the audit objectives and perform the work in accordance with *Government Auditing Standards*. The audit organization's management should assess skill needs to consider whether its staff has the skills that match those necessary to perform the particular audit. The Yellow Book at Paragraph 3.70 further states that an audit organization should have a process for recruitment, hiring, continuous development, assignment, and evaluation of staff to maintain a competent workforce.

105.27 The staff also should collectively possess the technical knowledge, skills, and experience necessary to be competent for the type of work being performed before beginning work on that audit. Paragraph 3.72 of *Government Auditing Standards* lists the technical knowledge, skills, and experience that staff should collectively possess:

- Knowledge of *Government Auditing Standards* applicable to the type of work they are assigned and the education, skills, and experience to apply the knowledge to the work being performed.

- General knowledge of the environment in which the audited entity operates and the subject matter.

- Skills to enable clear and effective oral and written communication.

- Skills appropriate for the work being performed; for example, skills in—

    - statistical or nonstatistical sampling if the work involves use of sampling;

    - information technology if the work involves review of information systems;

    - engineering if the work involves review of complex engineering data;

    - specialized audit methodologies or analytical techniques, such as the use of complex survey instruments, actuarial-based estimates, or statistical analysis tests, as applicable; or

    - specialized knowledge in subject matters, such as scientific, medical, environmental, educational, or any other specialized subject matter if the work calls for such expertise.

In addition, auditors performing financial audits should be knowledgeable in GAAS and GAAP or the special purpose framework being used.

105.28 The Yellow Book continuing education requirements are included as part of the competence general standard. According to Paragraph 3.76 of the Yellow Book, every two years each auditor performing work in accordance with the Yellow Book (including planning, directing, performing audit procedures, or reporting on an audit under the Yellow Book) should complete at least 24 hours of CPE that directly relates to government auditing, the government environment, or the specific or unique environment in which the auditee operates. In addition, auditors who do any amount of planning, directing, or reporting on Yellow Book audits, and auditors who are not involved in those activities but charge at least 20% of their time annually to Yellow Book audits, should also obtain at least another 56 hours (for a total of 80 hours in every two-year period) of CPE that enhances their professional proficiency to perform audits. At least 20 of the 80 hours should be completed in each year of the two-year period. Auditors hired or initially assigned to Yellow Book audits after the beginning of an audit organization's two-year CPE period should complete a prorated number of CPE hours. (It is important to note that the Yellow Book's CPE requirements apply whether the auditor is a CPA or is not certified.)

105.29 The Yellow Book, at Paragraph 3.77, states that determining what CPE subjects are appropriate to satisfy CPE requirements is a matter of professional judgment to be exercised by auditors in consultation with appropriate officials in their audit organization. In deciding appropriate CPE courses, auditors consider their experience, the responsibilities they have in a Yellow Book audit, and the operating environment of the audited entity.

105.30 The Yellow Book further states at Paragraph 3.78 that individual auditors are primarily responsible for improving their own competencies and meeting CPE requirements. However, audit firms should establish quality control procedures to help ensure that auditors meet CPE requirements, including documentation of CPE completed.

105.31 CPE Topics and Implementation Guidance. In April 2005, the GAO issued comprehensive guidance on CPE for auditors who perform Yellow Book engagements. *Guidance on GAGAS Requirements for Continuing Professional Education* (2005 Guidance) clarifies numerous CPE issues including measurement periods, 24-hour and 80-hour requirements, and CPE topics that meet the Yellow Book requirements. The concepts, but not the detailed guidance, of the 2005 Guidance have been incorporated into the Yellow Book. However, the 2005 Guidance is still applicable under the 2011 Yellow Book. Auditors may want to refer to it for identification of acceptable CPE topics. It is available on the GAO's website at **www.gao.gov**.

105.32 **Yellow Book Communication Requirements.** The Yellow Book states that auditors should make additional communications when performing Yellow Book audits. It also broadens the parties with whom auditors have to communicate and requires auditors to communicate specific information during the planning stage of a financial audit to reduce the risk that the needs or expectations of the parties involved may be misinterpreted. Yellow Book communication requirements are discussed more fully beginning at paragraph 202.14.

105.33 **Yellow Book Professional Judgment Requirements.** *Government Auditing Standards* establish an unconditional requirement that auditors must use professional judgment in planning, performing, and reporting on audits. Paragraph 3.61 of the Yellow Book states that professional judgment "includes exercising reasonable care and professional skepticism." The concept of reasonable care requires auditors to act diligently in accordance with applicable professional standards and ethical principles. Exercising professional skepticism entails a critical assessment of audit evidence while assuming that management is neither dishonest nor of unquestioned honesty.

105.34 The Yellow Book clearly states that professional judgment is both an organizational and individual responsibility. Paragraph 3.63 of the Yellow Book states—

> Professional judgment represents the application of the collective knowledge, skills, and experiences of all the personnel involved with an audit, as well as the professional judgment of individual auditors. In addition to personnel directly involved in the audit, professional judgment may involve collaboration with other stakeholders, external specialists, and management in the audit organization.

105.35 Paragraph 3.64 of the Yellow Book indicates that applying professional judgment includes—

- Following the independence standards and related conceptual framework;

- Maintaining objectivity and credibility;

- Assigning competent staff to the audit engagement;

- Defining the scope of work;

- Evaluating, documenting, and reporting the results of the work; and

- Maintaining appropriate quality control over the audit.

105.36 The GAS/SA Audit Guide, Paragraph 2.33, provides the following additional considerations relative to exercising professional judgment:

- The use of professional knowledge, skills, and experience to diligently gather information, in good faith and with integrity, and to objectively evaluate the sufficiency and appropriateness of evidence is a critical component of an audit. Professional judgment and competence are interrelated because judgments made are dependent upon the auditor's competence.

- Professional judgment represents the application of the collective knowledge, skills, and experiences of all the personnel involved with an audit, as well as the professional judgment of individual auditors. Professional judgment may also involve collaboration with other stakeholders, external specialists, and management in the audit organization.

- The use of professional judgment is important in performing all aspects of auditors' professional responsibilities, including following the independence standards and related conceptual framework; maintaining objectivity and credibility; assigning competent staff to the audit; defining the scope of work; evaluating, documenting, and reporting the results of the work; and maintaining appropriate quality control over the audit process.

- The use of professional judgment is important when applying the conceptual framework to determine independence for a specific situation. This includes the consideration of threats to independence and safeguards that may mitigate identified threats. Professional judgment is used to identify and evaluate any threats to independence, including those to the appearance of independence.

- The use of professional judgment is important in determining the required level of understanding of the audit subject matter and related circumstances. This includes consideration of whether the audit team's collective experience, training, knowledge, skills, abilities, and overall understanding are sufficient to assess the risks that the subject matter of the audit may contain a significant inaccuracy or could be misinterpreted.

- The consideration of the audit risk level, including the risk of arriving at improper conclusions, is also important. Exercising professional judgment in determining the sufficiency and appropriateness of evidence to be used to support the findings and conclusions based on the audit objectives and any recommendations reported is an integral part of the audit process.

105.37 *Government Auditing Standards* places responsibility on each auditor and the audit organization to exercise professional judgment in planning and performing an audit. However, it does not imply unlimited responsibility or infallibility on the part of an auditor or the audit organization.

105.38 **Yellow Book Reporting Requirements.** *Government Auditing Standards* contain several reporting requirements that exceed GAAS requirements. Additional reporting requirements include—

- Reporting on the auditor's compliance with *Government Auditing Standards*.
- Reporting on internal control and compliance with provisions of laws, regulations, contracts, and grant agreements.
- Reporting deficiencies in internal control, fraud, noncompliance, and abuse.
- Reporting views of responsible officials.
- Reporting confidential or sensitive information.
- Distributing reports.

These reporting requirements are discussed in Chapter 11.

105.39 **Yellow Book Quality Control and Assurance Requirements** *Government Auditing Standards* states that audit organizations conducting Yellow Book audits must establish and maintain a quality control system that is designed to provide reasonable assurance that the organization and its personnel comply with professional standards and applicable legal and regulatory requirements. The organization has to undergo an external peer review at least once every three years by reviewers independent of the audit organization being reviewed. The external peer review requirement has to be met (i.e., peer review report issued) within three years after starting a firm's first Yellow Book audit (i.e., the start of field work).

105.40 The Yellow Book, beginning at Paragraph 3.85, provides a listing of policies and procedures that should be addressed in the CPA firm's quality control system. The firm's quality control policies and procedures have to be documented and communicated to its personnel. The firm's compliance with its quality control policies and procedures should be documented and retained long enough for those performing monitoring procedures and peer reviews to evaluate the extent of its compliance with its quality control policies and procedures. At least annually, the organization should analyze and summarize the results of its monitoring procedures, including identification of any systemic or repetitive issues needing improvement and recommendations for corrective action.

105.41 According to Paragraph 3.106 of the Yellow Book, auditors seeking to enter into a contract to perform an audit in accordance with *Government Auditing Standards* should, if requested, provide the party contracting for the audit with the auditor's most recent peer review report and any subsequent peer review reports received during the period of the contract.

105.42 The Yellow Book at Paragraph 3.105 states that external audit firms should make their most recent peer review report publicly available. This can be done, for example, by posting the peer review report on a publicly available internet site or to a publicly available site designed for transparency of peer review results. If these options are not available, the audit firm should use the same mechanism it uses to make other information public, and provide the peer review report to others upon request.

Single Audit Standards

105.43 The Single Audit involves application of GAAS, *Government Auditing Standards*, and additional requirements found in the Single Audit Act and related OMB pronouncements. Those additional requirements extend beyond GAAS and *Government Auditing Standards* for financial audits in the following ways:

- Supplementary information on federal awards programs accompanies the basic financial statements and is reported on.

- Additional assessment of internal control over federal award programs beyond the minimum consideration required by GAAS and the Yellow Book, including tests of the operating effectiveness of internal control over compliance, and additional reporting on controls.

- Testing of additional transactions for compliance with federal statutes, regulations, and the terms and conditions of federal awards relevant to major federal awards programs and additional reporting providing an opinion on compliance.

105.44 **Summary of Additional Compliance Testing and Internal Control Responsibilities Audit Standards** Exhibit 1-5 presents the additional compliance testing and internal control requirements in a Single Audit conducted in accordance with the Uniform Guidance adapted from Table 15-1 of the GAS/SA Audit Guide. In-depth guidance on Single Audits is provided in Chapter 13 of this *Guide*.

Exhibit 1-5

Additional Compliance Testing and Internal Control Responsibilities in a Single Audit Conducted in Accordance with the Uniform Guidance

	Obtaining Sufficient Appropriate Audit Evidence	**Reporting Responsibilities**
Compliance Testing Responsibilities	The auditor must determine whether the auditee has complied with federal statutes, regulations, and the terms and conditions of federal awards that may have a direct and material effect on each of its major programs.	The auditor must report on compliance for each major program and express or disclaim an opinion about whether the auditee complied with federal statutes, regulations, and the terms and conditions of federal awards that could have a direct and material effect on each major program and, where applicable, refer to the separate schedule of findings and questioned costs.
Internal Control Responsibilities	With regard to internal control over compliance, the auditor must do the following: (1) perform procedures to obtain	The auditor must provide a written report on internal control over compliance for major

	an understanding of internal control over compliance for federal programs that is sufficient to plan the audit to support a low assessed level of control risk of noncompliance for major programs, (2) plan the testing of internal control over compliance for major programs to support a low assessed level of control risk of noncompliance for the assertions relevant to the compliance requirements for each major program, and (3) perform tests of internal control over compliance as planned (unless the internal control is likely to be ineffective in preventing or detecting noncompliance). The auditor may use evidence gained from the tests of controls over compliance to determine the nature, timing, and extent of the testing required to express an opinion on compliance with requirements that have a direct and material effect on each of its major federal programs.	programs describing the scope of internal control testing and the results of the tests, and, where applicable, refer to the separate schedule of findings and questioned costs.

---

[7] The OMB's *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance) significantly changes the requirements for federal award recipients and their auditors. The audit requirements in the Uniform Guidance are effective for audits of fiscal years beginning on or after December 26, 2014. The first audits that should be performed under the Uniform Guidance are for years ending December 31, 2015. The Uniform Guidance is discussed in detail in Chapter 13 and has been fully implemented throughout this *Guide* and related practice aids.

END OF DOCUMENT -

106 The PPC Audit Process

106.1 Generally accepted auditing standards require auditors to use information gathered about the entity and its environment (including internal control) to identify and assess the risks of material misstatement at both the overall financial statement and relevant assertion levels, and to determine the nature, timing, and extent of further audit procedures needed to respond to those risks. Further audit procedures are required to be performed to obtain audit evidence to support the auditor's opinion.

106.2 The authors have developed a practical approach to that audit process to address the requirements of authoritative literature and have designed practice aids to assist auditors in meeting those requirements. PPC's audit approach is designed to be flexible and adaptable, allowing auditors to better leverage their knowledge of the client to tailor their audit procedures. PPC has tailored this approach for use in all of our industry audit guides so that auditors can use a common audit approach in all of their audits. The audit approach has been divided into the following broad steps:

1 Perform procedures regarding acceptance/continuance of the client relationship, evaluate compliance with ethical requirements (including independence), and establish an understanding with the client in an engagement letter.

2 Develop a preliminary audit strategy, establish planning materiality, and perform risk assessment procedures to gather information about the entity and its environment that may be relevant in identifying risks of material misstatement of the financial statements and, if applicable, material noncompliance.

3 Gather the information to understand and evaluate the design and implementation of the entity's internal control system.

4 Synthesize the information gathered, identify risks (both overall and specific) that could result in material misstatement of the financial statements and, if applicable, material noncompliance, and finalize the overall audit strategy.

5 Assess the risks of material misstatement of the entity's financial statements and, if applicable, material noncompliance.

6 Develop and perform appropriate responses (further audit procedures) to the assessed risks of material

misstatement of the financial statements and, if applicable, material noncompliance considering the overall audit strategy and planning materiality.

7 Evaluate audit findings and evidence.

8 Prepare required reports and communications.

106.3 Although the requirements and guidance may suggest a sequential process, the audit is a continuous process of gathering, updating, and analyzing information about the fairness of presentation of amounts and disclosures in the client's financial statements. Therefore, the audit process is an iterative, nonlinear process, whereby the required procedures may be performed concurrently with other procedures. In addition, risks should be evaluated continuously throughout the audit.

Practice Aids

106.4 *PPC's Guide to Audits of Local Governments* contains practice aids that guide the auditor through the entire audit process. The practice aids included in this *Guide* are discussed in the related text guidance. By using the following practice aids, auditors can efficiently conduct an audit of a local government in accordance with authoritative literature:

• Firm policies (ALG-FP).

• Confirmations and correspondence letters (ALG-CL).

• Audit programs (ALG-AP).

•• Core audit programs (ALG-AP).

•• Specified risk audit programs (ALG-AP-S).

• Checklists and practice aids (ALG-CX).

106.5 **Checkpoint® Tools** *PPC's Guide to Audits of Local Governments* provides the following electronic practice aids that may provide even more efficiency when conducting an audit of a governmental entity:

• *PPC's Practice Aids.* PPC's *Practice Aids for Audits of Local Governments*, a companion product to this *Guide*, contains electronic versions of all practice aids included in this *Guide* that can be easily customized for each engagement.

• *PPC's SMART Practice Aids.* To assist auditors in complying with risk assessment procedures, the authors have developed a cutting-edge risk assessment tool called PPC's *SMART Practice Aids—Risk Assessment*. This tool interfaces with PPC's *Practice Aids* to help auditors automatically generate tailored audit programs based on their risk assessment for each client engagement.

• *PPC's SMART Practice Aids—Single Audit* automates the process of determining major programs, low-risk auditee status, and appropriate compliance requirements, and prepares the compliance audit program and schedule of expenditures of federal awards.

• *PPC's Workpapers.* PPC's *Workpapers for Local Governments* utilizes advanced diagnostics and dynamically changing content to create electronic workpapers common to government audits.

• *PPC's Disclosure Library.* PPC's *Interactive Disclosure Library for Governments* is an electronic version of the governmental disclosure checklist that provides hundreds of real-world disclosure examples that can easily be pasted into governmental financial statements.

106.6 PPC practice aids at the ALG-CX section of this *Guide* assist auditors in complying with professional standards and achieve an efficient workflow. At ALG-CX-0.1, the authors have indicated which practice aids should be completed on each engagement to fulfill specific professional standards. Additionally, the authors have indicated which practice aids generally, by themselves, do not fulfill a specific GAAS, Yellow Book, or Single Audit requirement and which practice aids assist auditors in situations that do not occur on every audit.

106.7 The auditor may choose to document audit procedures in a memo or in another form rather than using a PPC practice aid. To ensure that the alternative documentation meets GAAS, Yellow Book, or Single Audit requirements, the authors recommend that auditors read the practice aid for an indication of the matters to be considered and documented. As a general rule of thumb, the alternative documentation should address the subtitles in the PPC practice aids, thereby indicating how all the major areas for consideration in the practice aid are addressed. Case Study 2 in Appendix B of *PPC's Guide to Audit Risk Assessment* illustrates the PPC audit process using a combination of completed PPC practice aids and memos that replace certain practice aids.

END OF DOCUMENT -

107 Organization of This *Guide*

107.1 As previously noted, this *Guide* provides a step-by-step approach to providing audit services for governmental entities. The following chapters discuss the organization of this *Guide* in more detail:

- *Chapter 2* —“Pre-engagement Activities” explains the activities that take place (a) before an engagement is accepted and (b) in the early planning stages of an engagement. This chapter also discusses considerations relating to audits of group financial statements, service organizations, and the use of specialists.

- *Chapter 3* —“Risk Assessment Procedures and Planning” focuses on general planning decisions, such as deciding on an overall strategy for the audit, obtaining an understanding of the entity and its environment (including its internal control), making an initial assessment of audit risk and materiality, and deciding on the overall timing of the engagement.

- *Chapter 4* —“Assessing Risks and Developing the Detailed Audit Plan” focuses on (a) assessing the risks identified by the auditor throughout the process of performing the risk assessment procedures and (b) selecting responses that are appropriate to address those risks. The result of the auditor's risk assessment is the preparation of a detailed audit plan describing the nature, timing, and extent of further audit procedures.

- *Chapter 5* —“Substantive Procedures” discusses the application of substantive procedures, which consist of tests of details and substantive analytical procedures. Included in the chapter is a discussion of substantive procedures that are required in every audit.

- *Chapter 6* —“Testing Internal Control” discusses tests of controls, including circumstances when tests of controls should be performed and circumstances when testing would be unnecessary or inefficient. This chapter discusses the nature of tests of controls, including inquiry and observation, inspection of documents, walkthroughs, review of reconciliations and similar bookkeeping routines, and reperformance of control activities.

- *Chapter 7* —“Sampling in an Audit Engagement” explains how to decide the extent of audit tests, including the number of components to be tested, cutoff amounts for individually significant dollar items, and sample sizes.

• *Chapter 8* —“Audit Documentation” focuses on the documentation necessary to comply with professional standards and on techniques and approaches for efficient workpaper organization and preparation.

• *Chapter 9* —“Audit Programs” explains the organization, format, and use of the audit programs presented in this *Guide*, as well as the special accounting and auditing considerations related to the financial statement account groupings covered by the audit programs.

• *Chapter 10* —“Concluding the Audit” addresses the general procedures that are necessary during the concluding phase of the audit. The general procedures discussed in this chapter are:

  •• Procedures to search for commitments and contingencies, including obtaining lawyers' letters and other procedures relating to litigation, claims, and assessments.

  •• Obtaining written representations from management in a management representation letter.

  •• Procedures to search for subsequent events.

  •• Procedures to identify and evaluate the disclosure of related-party relationships and transactions.

  •• Evaluation of whether there is a substantial doubt about the entity's ability to continue as a going concern.

  •• Procedures to identify and evaluate the measurement and disclosure of risks and uncertainties, estimates, and fair value.

  •• Procedures to summarize and evaluate the overall results of audit tests, including the evaluation of uncorrected misstatements.

  •• Concluding on the form of opinion on the financial statements, and communicating that opinion and other significant conclusions in written and oral reports.

• *Chapter 11* —“Auditor's Reports” explains and illustrates the various types of auditor's reports that are commonly issued for local governments.

• *Chapter 12* —“Special Considerations in a School District Audit” provides an overview of school districts and discusses their unique audit considerations.

• *Chapter 13* —“Single Audits” discusses when and how an auditor performs a Single Audit of a local government.

END OF DOCUMENT -