

2004

## State and local governmental developments - 2004

American Institute of Certified Public Accountants. Auditing Standards Division

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A U D I T   R I S K   A L E R T S

# State and Local Governmental Developments — 2004

*Strengthening Audit Integrity  
Safeguarding Financial Reporting*

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

**AICPA**

# State and Local Governmental Developments — 2004

*Strengthening Audit Integrity  
Safeguarding Financial Reporting*

## Notice to Readers

We, as members of the AICPA staff, have developed this Audit Risk Alert to provide you, as an auditor of financial statements of state and local governments, with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits you perform. This document presents brief summaries of recently issued accounting and auditing pronouncements and legal and regulatory provisions. We present those summaries for your information only; you should not rely on them as a substitute for a complete reading of the source material.

This publication is an *Other Auditing Publication* as defined in Statement on Auditing Standards (SAS) No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150), as amended. Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply the SASs.

If an auditor applies the auditing guidance included in an Other Auditing Publication, he or she should be satisfied that, in his or her judgment, it is both appropriate and relevant to the circumstances of his or her audit. This publication was reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

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# ***State and Local Governmental Developments—2004***

## **Economic and Industry Developments**

### **The State of the Economy**

Nationally, certain economic indicators are showing recovery, and state governments are starting to see some minor easing of the severe economic conditions they have faced the past few years. State tax revenues are increasing—and although much of that increase results from tax increases and inflation, real growth in underlying tax bases is reaching pre-recession levels. Different states, however, are in different points along the recovery continuum. The tax base with the most real growth is individual income. Improving financial markets also may increase a government's investment income, particularly governments with large stock portfolios, such as public employee retirement systems.

In fiscal year 2004, states continued to use various measures to address both near-term budget shortfalls and long-term structural deficits. Those measures included tax increases; tax restructuring; across-the-board budget cuts; hiring freezes; layoffs; early retirement incentives; program restructuring; debt refinancings; using tobacco settlement payments to securitize bonded debt; and using rainy-day funds. Some states have offered tax amnesty programs, waiving penalties, and offering lower interest rates during a specific time period to collect unpaid back income and sales taxes. Some states are increasing the scope and intensity of their tax audit activity to search out unpaid taxes, some by outsourcing the audit activity to private sector entities or by using “self-audit” programs, where the taxpayer performs the review and provides the results to the state. Demands for social service programs and Medicaid continue to place great pressure on state budgets, making those programs large targets for near- and long-term cost containment measures.

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The national and state economies continue to place fiscal stress on local governments. In a recent survey of cities and towns by the National League of Cities, twice as many respondents indicated worsened fiscal conditions than reported improved conditions in calendar year 2003. More than four out of five cities and towns in that survey reported being less able to meet their financial needs compared with the previous year, and expected to be even less able to meet those needs in calendar year 2004. Many states cut aid to local governments; it has been reported that states cut \$2.3 billion in aid to cities in their fiscal year 2004 budgets. In some states, the cut in that aid was accompanied by the authority to institute new local taxes. States also are increasing their cuts or delaying their payments of aid for elementary and secondary education. Many local governments that had hoped to receive federal homeland security funding through their state governments have not received the funding that has been allocated to them or have not been notified that they will receive an allocation. In general, local governments continue to cut services, staff, and spending on infrastructure and maintenance, draw down reserves, and increase fees and taxes, particularly property taxes.

We find it prudent to repeat our “alert” message from last year: In the face of financial pressures, some governments may consider using “creative” budgeting, financing, and financial reporting techniques to avoid the appearance of deficit financial positions. They may seek innovative ways to minimize the reporting of costs, maximize the reporting of revenues and unrestricted net assets, and use restricted resources for unrestricted purposes. You should strongly consider the pressure a government’s economic situation places on it when planning and performing auditing procedures.

## **Taxation of Internet Sales**

The Internet Tax Nondiscrimination Act (Public Law [P.L.] 107-075) expired on November 1, 2003. That Act banned new Internet access taxes and new, multiple, and discriminatory taxes on electronic commerce (Internet sales). Bills introduced in Congress in 2004 separate the issue of taxes on Internet access from

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the issue of taxes on Internet sales, although as of the writing of this Alert, none of those bills has yet resulted in final legislation. In April 2004, the Senate overwhelmingly passed a bill that extends the moratorium on Internet access taxes for four years until November 1, 2007, but includes grandfathering provisions for jurisdictions that have been collecting such taxes. The House, which passed a bill in fall 2003 calling for a permanent ban of access taxes, still needs to consider the Senate measure. Another bill would permit Internet sales taxes provided the states simplify their sales tax laws. The states continue to make progress on that simplification, making Internet sales taxation probable should the proposed Streamlined Sales and Use Tax Act become law. Meanwhile, more retailers are joining the ranks of those voluntarily collecting taxes on Internet sales and several states have added lines on their income tax forms seeking to recover some of the estimated \$10 billion lost nationally each year on uncollected sales taxes for Internet and mail order purchases.

## **Regulatory, Legislative, and Other Developments**

### **Internal Revenue Service Activities**

Internal Revenue Service (IRS) activities might affect the financial statement audits of your state and local government clients; noncompliance with federal tax requirements could have a direct and material effect on the determination of financial statement amounts.

This year, the IRS is using both outreach and compliance initiatives with state and local governments to focus on issues relating to, among other matters, taxable fringe benefits, worker versus independent contractor classification, volunteer compensation, Section 218 agreements, Federal Insurance Contribution Act (FICA) taxes, questionable Form W-4s, information return (Form 1099) reporting requirements and backup withholding situations, tax-sheltered annuities and deferred compensation plans, and yield burning and arbitrage on tax-exempt bonds. In addition, changes in U.S. Department of the Treasury (Treasury) regulations, some of which we highlight below, might result in

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changes in a government's activities relating to, for example, its retirement plans or tax-exempt debt.

Information on most of these issues can be found on the IRS Web site. The portion of the IRS Web site ([www.irs.gov](http://www.irs.gov)) relating to the Tax Exempt and Government Entities (TE/GE) Operating Division:

- Provides separate pages for state and local governments ([www.irs.gov/govts](http://www.irs.gov/govts)), Indian tribal governments ([www.irs.gov/tribes](http://www.irs.gov/tribes)), tax-exempt bonds ([www.irs.gov/bonds](http://www.irs.gov/bonds)), and employee retirement plans ([www.irs.gov/ep](http://www.irs.gov/ep)).
- Provides links to relevant regulations, revenue rulings, revenue procedures, notices, announcements, various forms and publications (such as Publications 963, *Federal-State Reference Guide: Social Security Coverage and FICA Reporting by State and Local Government Employers*; 3908, *Gaming Tax Law for Indian Tribal Governments*; and 4079, *Tax-Exempt Governmental Bonds Compliance Guide*), frequently asked questions, fact sheets on major issues, and educational products.
- Allows you to access and subscribe to electronic newsletters, such as the *Federal, State, and Local Governments Newsletter* and *Employee Plans News*, which provide timely information and analysis about current developments.
- Gives you information about outreach efforts, voluntary correction programs, and contacts for appropriate IRS and other federal agency personnel.

### **Government Affirmation Letters**

Charitable organization grant applications or donors might ask a government to provide a “determination letter” to prove its status as a “tax exempt” or charitable entity. For a government to receive a determination of its tax-exempt status, it must pay a fee to obtain a letter ruling. As an alternative, a government can call (877) 829-5500 and obtain a free “government affirmation letter.” That letter is issued based on information the IRS possesses that indicates that an organization appears to be a governmental entity.

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The IRS states that most organizations and individuals will accept a government affirmation letter in lieu of a determination letter as substantiation.

### **Employment Issues**

***Compliance activities.*** The TE/GE office of Federal, State, and Local Governments (FSLG) has announced that it will shift its emphasis this year from mostly outreach to mostly compliance activities—processing claims for refunds, reviewing tax returns for correctness (compliance checks), and performing examinations. The FSLG also plans to implement a Voluntary Compliance Agreement Program (VCAP) this year for employment tax issues. VCAP programs provide appropriate remedies when an entity voluntarily comes forward and expresses a desire to resolve certain issues.

***Student exception to FICA tax.*** In the February 25, 2004, *Federal Register* (69 FR 8604), the IRS published proposed regulations on the student exception to FICA tax. The IRS also published Notice 2004-12 (*Internal Revenue Bulletin* 2004-10, March 8, 2004) containing a proposed revenue procedure that provides “safe harbor” rules for treating certain student workers as exempt from FICA. That guidance, which is effective for services performed on or after February 25, 2004, tries to close out the long-running controversy over the dividing line between work as an adjunct to study and study as an adjunct to essentially full-time work. Governmental colleges and universities should carefully review its provisions.

**Help Desk**—The March 2004 edition of the IRS’s *Federal, State, and Local Governments Newsletter*, available at [www.irs.gov/pub/irs-tege/mar04\\_fslg.pdf](http://www.irs.gov/pub/irs-tege/mar04_fslg.pdf), highlights the provisions of Notice 2004-12.

***Home-care services.*** IRS Notice 2003-70 (*Internal Revenue Bulletin* 2003-43, October 27, 2003) contains a proposed revenue procedure giving updated guidance to state and local governments on how they can serve as employment tax agents to report and pay employment taxes on behalf of disabled individuals and other welfare recipients who employ home-care service providers to

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assist them in their homes. (Note that under the Internal Revenue Code [IRC], all provisions of law, including penalties, applicable to employers are applicable to an employment tax agent and remain applicable to the employer. Thus, the employer and the agent designated to fulfill the employer's duties to withhold, report, or pay employment taxes are both independently liable for the employment taxes.) No effective date was proposed; the final version of the revenue procedures will indicate an effective date.

**Help Desk**—The December 2003 edition of the IRS's *Federal, State, and Local Governments Newsletter*, available at [www.irs.gov/pub/irs-tege/dec03\\_fslg.pdf](http://www.irs.gov/pub/irs-tege/dec03_fslg.pdf), highlights the provisions of Notice 2003-70.

### **Tax-Exempt Bonds**

**Compliance activities.** The primary IRS compliance activities for tax-exempt bonds continue to concern yield burning, arbitrage, and the appropriate use of bond proceeds. In addition to the areas of interest that we discussed in last year's Alert, we expect IRS examiners to become active in reviews of so-called "telephone book TEFRA"<sup>1</sup> bonds. These are situations in which the issuance documents for municipal bonds list several hundred possible projects with no real commitments. (In fact, many of the owners of the potential projects have never been consulted, hence the name "telephone book TEFRA" bonds, suggesting that the issuer just went through the phone book and listed every other business as having a potential project.) Concerning arbitrage, auditors should be aware that in addition to ongoing efforts to identify state and local governments that have not computed and rebated to the Treasury the arbitrage earned on the investment of proceeds of municipal obligations, IRS examiners have been increasing their reviews of practices that reduce or eliminate arbitrage rebate through various diversion schemes. A widely employed technique that has resulted in several recent settlement payments from governments is the purchase of an "escrow put" from proceeds of advance refunding bonds to "burn" positive arbitrage in

1. TEFRA is an acronym for the Tax Equity and Fiscal Responsibility Act of 1982 (Public Law 97-248). Among its other provisions, that Act established some of the public notice requirements for tax-exempt bonds, which became known in the industry as TEFRA requirements.

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the advance refunding bond escrow. The IRS has developed a standardized settlement as part of its tax-exempt bond VCAP to resolve this issue while protecting the interest paid on the municipal obligations from taxation.

As we discussed in last year's Alert, a problem to which auditors should be alert is a change in the use of financed facilities. Bond proceeds may be used to finance a project that is initially eligible for tax-exempt financing, but the use of the property later changes to an ineligible use (for instance, a government that no longer needs space for its own purposes could lease that space to a private business or the federal government, or a government could privatize a service that uses bond-financed facilities). If this should occur with respect to any portion of such a facility, the government should consult a competent tax adviser about the consequences.

**Help Desk**—In the 2002 Alert, we discussed in detail the IRS's tax-exempt bond VCAP. That program continues in full force and can be a useful tool to resolve problems that a government discovers with its tax-exempt bonds. See the IRS Web site at [www.irs.gov/pub/irs-irbs/irb01-40.pdf](http://www.irs.gov/pub/irs-irbs/irb01-40.pdf) for more details.

***Naming rights.*** A new issue this year is the sale of naming rights to a facility. In Private Letter Ruling (PLR) 200323006, dated June 6, 2003, the IRS concluded that selling naming rights gives rise to private business use. The IRS has not yet proposed regulations for this issue, but you should consider advising your governmental clients that have or are considering selling naming rights to facilities of the IRS position.

***Record retention requirements.*** During an examination, the IRS will request all material records and information necessary to support a municipal bond issue's compliance with the IRC. The IRS Web site contains a page of frequently asked questions (FAQs) concerning how certain IRC record retention requirements apply to tax-exempt bond transactions. The site gives answers to questions concerning, for example, the basic records that should be retained and how long records should be kept. A failure to properly maintain required records may have a negative financial effect on the bond holder, issuer, or conduit borrower.

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**Help Desk**—The FAQs regarding record retention requirements are available on the IRS Web site at [www.irs.gov/govt/article/0,,id=119336,00.html](http://www.irs.gov/govt/article/0,,id=119336,00.html).

*Qualified zone academy bond regulations.* In the March 26, 2004, *Federal Register* (69 FR 15747), the Treasury issued proposed regulations to provide amended guidance for qualified zone academy bonds (QZABs), which are tax credit bonds that state and local governments issue for the benefit of certain public schools to rehabilitate or repair public school facilities, provide equipment, develop course materials, and train teachers and other school personnel. The regulations, which address the maximum term, permissible use of proceeds, and remedial actions for QZABs, would apply to bonds sold on or after the date that is 60 days after publication of final regulations in the *Federal Register*. In general, issuers may apply the proposed regulations to bonds sold before that effective date.

*Arbitrage and private activity restrictions regulations.* In the September 8, 2003, *Federal Register* (68 FR 52975), the Treasury issued final regulations for determining whether a prepayment for property or services results in a private loan or investment-type property for purposes of the arbitrage and private activity restrictions applicable to tax-exempt bonds issued by state and local governments. Those regulations were prompted by, among other concerns, governments that issued tax-exempt bonds to make prepayments for future natural gas supplies; guidance had been needed to make clear which forms of such arrangements are acceptable, and which are not. Those regulations are effective October 3, 2003. In addition, in the December 11, 2003, *Federal Register* (68 FR 69020), the Treasury issued regulations that provide guidance for determining when certain brokers' commissions or similar fees are qualified administrative costs for purposes of the arbitrage restrictions. Those regulations are effective February 9, 2004.

**Help Desk**—The IRS recently issued a guide to provide an overview of federal tax law requirements pertaining to tax-exempt qualified private activity bonds issued by a state or local government, the proceeds of which are used by a 501(c)(3)

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charitable organization in furtherance of its exempt purpose. Publication 4077, *Tax-Exempt Bonds for 501(c)(3) Charitable Organizations*, is available on the IRS Web site at [www.irs.gov/pub/irs-pdf/p4077.pdf](http://www.irs.gov/pub/irs-pdf/p4077.pdf).

## Employee Plans

**Compliance activities.** In its compliance activities for retirement plans sponsored by state and local governments, the IRS is emphasizing the review of the following items:

- 457(g) trust compliance
- Ineligible employer sponsors of 403(b) and 457 plans
- Defaulted plan loans
- Hardship and unforeseeable emergency distributions not meeting requirements
- IRC section 402(g) and section 457(b) contributions in excess of the basic limits and the special 457 catch-up limit
- Compliance with the final regulations on eligible section 457(b) deferred compensation plans issued in the July 11, 2003, *Federal Register* (68 FR 41230), which were effective upon issuance and generally applicable to taxable years beginning after December 31, 2001, and which establish form and operational requirements
- Substantial risk of forfeiture under section 457(f) arrangements

The IRS has been running a pilot program to identify plan sponsors of what appear to be ineligible IRC section 403(b) or 457(b) plans. One area it has been looking at is 403(b) plan contributions by non-educational governmental employers—employers that are not eligible to sponsor a 403(b) plan. When the IRS discovers such employers, it directs them to its Employee Plans Compliance Resolution System (EPCRS), the comprehensive system of correction programs for sponsors of retirement plans that have failed to meet one or more requirements of the IRC. Through this compliance initiative, the IRS has observed a few IRC section 501(c)(3) charitable hospitals being reorganized as

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county hospitals and not ending contributions to their IRC section 403(b) plans. The proper replacement plan in this situation would be an IRC section 457(b) plan.

Further, concerning the EPCRS, we want to mention that on June 5, 2003, the IRS issued Revenue Procedure 2003-44 (*Internal Revenue Bulletin* 2003-25, June 23, 2003) to significantly streamline the EPCRS process.

**Help Desk**—The IRS makes available a Retirement Plan Corrections Program CD-ROM, which includes information on the EPCRS. You can call (800) 829-3676 or order it through the educational services link on the IRS employee plans Web site at [www.irs.gov/ep](http://www.irs.gov/ep).

**Catch-up contribution regulations.** In the July 8, 2003, *Federal Register* (68 FR 40510), the IRS published final regulations to provide guidance on “catch up contributions,” which were added to the IRC by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) (P.L. 107-016). Catch-up contributions increase the amount of elective deferrals that a catch-up eligible participant may exclude from income and can be made to, among other retirement plans, section 403(b) tax-sheltered annuity contracts and section 457 eligible governmental plans. Those regulations are applicable to contributions in taxable years beginning on or after January 1, 2004.

**Retirement plan amendments for EGTRRA.** Many employers are still amending and redesigning their retirement plans to reflect the changes made by the EGTRRA. (The 2002 Alert provided an overview of the effect of the EGTRRA.) Although the final deadline for plan amendments is not until the end of the 2005 plan year, plans normally should be amended before then to take advantage of opportunities created by the new law.

## **Securities and Exchange Commission Activities**

In last year’s Alert, we discussed the work of the Municipal Council to establish a single electronic filing location (commonly referred to as an electronic “post office”) for municipal securities issuers and conduit borrowers to use to provide financial statements

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and other financial information to the nationally recognized municipal securities information repositories (NRMSIRs). The Municipal Advisory Council of Texas is establishing a Web site for that purpose at [www.DisclosureUSA.org](http://www.DisclosureUSA.org). The Securities and Exchange Commission (SEC) supports the Municipal Council's efforts and, once DisclosureUSA is fully operational, plans to consider mandating the use of that site for all NRMSIR filings. For purposes of such electronic filings, auditors should consider advising their governmental clients that are issuers and conduit borrowers to produce their financial statements in a secure electronic format, such as a portable document format (PDF) file.

### **Equal Employment Opportunity Commission Activities**

The Equal Employment Opportunity Commission (EEOC) published proposed regulations in the July 14, 2003, *Federal Register* (68 FR 41542), that would overturn the Third Circuit Court of Appeals' decision in *Erie County Retirees Association v. County of Erie*. The proposal would explicitly authorize reductions in retiree health benefits to reflect Medicare eligibility, a common practice that the Erie case threw into doubt. The proposal would become effective on the date of publication of a final rule in the *Federal Register*, and is expected to apply to existing, as well as newly created, employer-provided retiree health benefit plans. The EEOC expects to publish a final regulation by September 30, 2004. If the regulations are finalized as proposed, auditors may observe changes in a government's health benefit plan to provide differential benefits to active employees and retirees. Alternatively, the proposal may remove uncertainties about contingencies associated with plans that previously have had differential benefits.

### **The Sarbanes-Oxley Act of 2002**

The Sarbanes-Oxley Act of 2002 (the Act) (P.L. 107-204) provides new requirements for publicly-held companies and other "issuers" as defined in section 2(a)(7) of the Act.<sup>2</sup> Since the Act's issuance,

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2. Issuers, as defined by the Sarbanes-Oxley Act of 2002 (the Act), and other entities when prescribed by the rules of the Securities and Exchange Commission (SEC), and their public accounting firms (who must be registered with the Public Company Accounting Oversight Board [PCAOB]) are subject to the provisions of the Act, implementing SEC regulations, and the rules and standards of the PCAOB, as appropriate.

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several state's legislators, regulators, and other elected or appointed officials have sought to duplicate or extend provisions of the Act to nonpublic companies. Further, the General Accounting Office (GAO), which issues *Government Auditing Standards*, has stated that it will be monitoring the actions of the AICPA and the new Public Company Accounting Oversight Board (PCAOB) (which was established by the Act) to determine if any changes, updates, or clarifying guidance needs to be added to its auditing standards. It is not clear at this point if or how these activities will affect audits of state and local governments. For this reason, you may want to follow developments related to the Act. As of the writing of this Alert, certain PCAOB standards and rules have been issued as final pronouncements approved by the SEC, and some still require SEC approval before they become effective. In addition, the PCAOB has issued exposure drafts of additional proposed standards and rules.

**Help Desk**—For information about the Sarbanes-Oxley Act, see the Sarbanes-Oxley Act/PCAOB Implementation section of the AICPA Web site at [www.aicpa.org/sarbanes/index.asp](http://www.aicpa.org/sarbanes/index.asp). That section includes background information; links to AICPA implementation guidance; and information on federal regulator, state regulator, and PCAOB activities related to the implementation of the Act. Further, a full listing of the proposed and final PCAOB standards and rules and links to those documents is on the PCAOB Rulemaking page at [www.pcaobus.org/pcaob\\_rulemaking.asp](http://www.pcaobus.org/pcaob_rulemaking.asp). In addition, you may want to periodically look at the GAO's Yellow Book Web site at [www.gao.gov/govaud/ybk01.htm](http://www.gao.gov/govaud/ybk01.htm) to follow any GAO actions or guidance issued in this area. That Web site also includes GAO comment letters on AICPA and PCAOB proposals. Finally, the AICPA answers individual questions at the Sarbanes-Oxley hotline: (866) 265-1977.

## **Audit and Attestation Issues and Developments**

This section discusses relevant auditing and attestation proposals and standards, Audit and Accounting Guides, and other guidance that have been issued, revised, or become effective since the

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publication of last year's Alert. For information on AICPA guidance issued subsequent to the writing of this Alert, please refer to the AICPA Web site at [www.aicpa.org/members/div/auditstd/technic.htm](http://www.aicpa.org/members/div/auditstd/technic.htm). You also may look for announcements of newly issued proposals and standards in the *CPA Letter*, including the *Members in Government* Supplement; the *Journal of Accountancy*; and the quarterly electronic newsletter "In Our Opinion" issued by the AICPA's Auditing Standards team and available at [www.aicpa.org/members/div/auditstd/opinion/index.htm](http://www.aicpa.org/members/div/auditstd/opinion/index.htm).

**Help Desk**—To obtain copies of AICPA standards and other guidance, contact the Member Satisfaction Center at (888) 777-7077 or go online at [www.cpa2biz.com](http://www.cpa2biz.com).

## **Recent AICPA Auditing Standards and Other Guidance**

### **SAS No. 101, *Auditing Fair Value Measurements and Disclosures***

Generally accepted accounting principles (GAAP) require fair value measurements and disclosures for many investments and investment-related transactions. For example, Governmental Accounting Standards Board (GASB) Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, as amended, requires that investments be reported at fair value. Issued in January 2003, SAS No. 101, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1, AU sec. 328), establishes standards and provides guidance on auditing fair value measurements and disclosures contained in financial statements. More specifically, SAS No. 101 addresses audit considerations relating to the measurement and disclosure of assets, liabilities, and specific components of equity presented or disclosed at fair value in financial statements. SAS No. 101 is effective for audits of financial statements for periods beginning on or after June 15, 2003, with earlier application permitted.

### **2004 Conforming Changes to Audit and Accounting Guides**

***State and Local Governments Guide***. We have updated the AICPA's Audit and Accounting Guide *State and Local Governments* for conforming changes as of May 1, 2004. (As explained in previous

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years' Alerts, the AICPA has been publishing two editions of the Audit and Accounting Guide for state and local governments—a GASB 34 edition and a non-GASB 34 edition. *State and Local Governments* is the update of the GASB 34 edition of the Guide. The AICPA will no longer update the non-GASB 34 edition of the Guide, although it will make electronic and printed copies available for a limited time.) An appendix in the Guide details all changes. We made revisions for or added information to alert auditors to the issuance or effective dates of (1) SASs through SAS No. 101; (2) the *Government Auditing Standards 2003 Revision* (2003 *Government Auditing Standards*) issued by the General Accounting Office (see the discussion of these new standards later in this section of this Alert); (3) GASB pronouncements through Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, and Technical Bulletin (TB) 2004-1, *Tobacco Settlement Recognition and Financial Reporting Entity Issues*; and (4) additional guidance in the GASB staff's *Comprehensive Implementation Guide—2003*. We also revised the Guide to discuss considerations for expressing an “in relation to” opinion on prior-year required supplementary information (RSI) and supplementary information other than RSI (known as SI) that accompanies the current-year financial statements when the basic financial statements for the prior year are not presented in the financial report.

**Help Desk**—For copies of the Guide with conforming changes through May 1, 2004 (product no. 012664kk), call AICPA Member Services at (888) 777-7077. See also the “References for Additional Guidance” section later in this Alert.

***Government Auditing Standards and Circular A-133 Audits Guide.*** We also have updated the AICPA's Audit Guide *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards* for conforming changes as of May 1, 2004. The Guide has a new title—*Government Auditing Standards and Circular A-133 Audits*. We chose that new title to better reflect the content of the Guide. We reorganized the Guide to separate *Government Auditing Standards* guidance from guidance related to audits conducted in accordance with the Single Audit Act Amendments of 1996 (the Single Audit Act) and Office of

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Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (Circular A-133). We also made changes for the Circular A-133 revision as of June 27, 2003. (See the discussion of that revision in the Audit Risk Alert titled *Single Audits—2004*.) Further, we made numerous changes to incorporate the provisions of the 2003 *Government Auditing Standards* (see the discussion of these new standards later in this section of this Alert). An appendix in the Guide describes the changes. Significant among the changes made to the Guide are:

- Guidance on the auditor’s consideration of abuse and the auditor’s reporting of findings of abuse and fraud in a financial audit.
- A revision to the *Government Auditing Standards* linkage paragraph in the auditor’s report on the financial statements to indicate, if applicable, that the *Government Auditing Standards* report does not provide an opinion on the internal control over financial reporting or on compliance.
- Clarification that the *Government Auditing Standards* report should include findings for all instances of fraud and illegal acts as applicable to the objectives of the audit unless clearly inconsequential. In a Circular A-133 audit, the auditor should apply a financial statement materiality consideration in reporting in the *Government Auditing Standards* report fraud and illegal acts involving federal awards that are subject to Circular A-133 reporting. That is because those findings already are reported in the Circular A-133 report.

**Help Desk**—We suggest that you closely review the illustrative auditor’s reports in the AICPA Audit Guide *Government Auditing Standards and Circular A-133 Audits* for the various changes resulting from this year’s conforming changes. For copies of the Guide with conforming changes through May 1, 2004 (product no. 012744kk), call AICPA Member Services at (888) 777-7077. See also the “References for Additional Guidance” section later in this Alert.

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## Two New Governmental Practice Aids

In the past year, the AICPA has issued two documents in its AICPA Audit and Accounting Practice Aid series of interest to preparers and auditors of governmental financial statements. One is *Applying OCBOA in State and Local Governmental Financial Statements*. A significant number of state and local governments prepare their financial statements using an other comprehensive basis of accounting (OCBOA), as defined in SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623.04). With the issuance of GASB Statement No. 34, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments*, questions have developed regarding the applicability of those financial reporting requirements to OCBOA financial statements. This nonauthoritative Practice Aid provides guidance in preparing OCBOA financial statements for state and local governments and for the appropriate auditor reporting on those financial statements in accordance with SAS No. 62 and the AICPA Audit and Accounting Guide *State and Local Governments*.

The other Practice Aid, *Auditing Governmental Financial Statements: Programs and Other Practice Aids*, is a nonauthoritative companion to *State and Local Governments* and addresses generally accepted auditing standards (GAAS) audits of financial statements prepared in conformity with GASB Statement No. 34. Organized using the sequencing as *State and Local Governments*, this publication primarily comprises illustrative audit programs and other practice aids, such as an engagement letter, a management representation letter, and deposit and investment confirmations. An accompanying CD-ROM includes an electronic version of each practice aid. The Practice Aid also has a case study on selecting, evaluating the results of, and reporting on opinion units that could be used as a staff training tool.

**Help Desk**—For copies of the Practice Aids (products no. 003314kk and 006602kk), call AICPA Service Center Operations at (888) 777-7077. See also the “References for Additional Guidance” section later in this Alert.

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### Practice Alert 2003-3

The AICPA's Professional Issues Task Force (PITF) develops Practice Alerts to help auditors improve the efficiency and effectiveness of their engagements. The AICPA *Audit Risk Alert—2003/04*, which is issued in the fall, lists the new Practice Alerts. In January 2004, the PITF issued Practice Alert 2003-3, *Acceptance and Continuance of Clients and Engagements*. The Practice Alert provides guidance on various aspects of an effective client acceptance program, such as communication with predecessor accountants or auditors and independence and objectivity.

**Help Desk**—A listing of and access to the AICPA PITF Practice Alerts is on the AICPA Web site at [www.aicpa.org/members/div/auditstd/pract\\_alerts.asp](http://www.aicpa.org/members/div/auditstd/pract_alerts.asp).

### Audit Committee Toolkit

The AICPA's Audit Committee Effectiveness Center is a Web-based source of resources to assist audit committees in their role in the corporate governance process. A recent resource added to the site is the *AICPA Audit Committee Toolkit*, which provides comprehensive advice on audit committee duties such as agenda-setting, conducting executive sessions, and evaluating the effectiveness of auditors and the audit committee itself. It also offers basic information on important topics such as internal controls, antifraud accountability, and off-balance-sheet transactions. The electronic version of the toolkit is available in Microsoft Word to allow customization to the needs of individual organizations or to specific industries or environments, such as government. The AICPA plans to release a government-specific version of the toolkit later this year. You may wish to suggest the use of the toolkit and other resources on the Audit Committee Effectiveness Center's site to your audit clients.

**Help Desk**—The AICPA's Audit Committee Effectiveness Center Web site is at [www.aicpa.org/audcommctr/homepage.htm](http://www.aicpa.org/audcommctr/homepage.htm). The *AICPA Audit Committee Toolkit* is on that site at [www.aicpa.org/audcommctr/toolkits/homepage.htm](http://www.aicpa.org/audcommctr/toolkits/homepage.htm). The government-specific toolkit is expected to be available on that site by September 2004.

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## Recent AICPA Attestation Standards

In September 2003, the AICPA issued Attest Interpretation No. 5, “Attest Engagements on Financial Information Included in XBRL Instance Documents,” of Chapter 1, “Attest Engagements,” of Statement on Standards for Attestation Engagements (SSAE) No. 10, *Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT sec. 9101.47-.54). Interpretation No. 5 explains the terms *XBRL* and *XBRL instance document* and the practitioner’s considerations when engaged to examine and report on whether an XBRL instance document accurately reflects the financial information it includes.

## Proposed AICPA Auditing Standards

In last year’s Alert, we informed you of the issuance of three proposed SASs and one proposed SSAE relating to the Sarbanes-Oxley Act of 2002, including its requirement that auditors of public company financial statements report on the effectiveness of management’s internal control over financial reporting. The AICPA submitted recommendations relating to those proposed standards to the PCAOB later in 2003.

**Help Desk**—For information about the AICPA submissions to the PCAOB, see the Sarbanes-Oxley Act/PCAOB Implementation section of the AICPA Web site at [www.aicpa.org/sarbanes/index.asp](http://www.aicpa.org/sarbanes/index.asp).

### Proposed SAS, *Communication of Internal Control Related Matters Noted in an Audit*

This SAS would supersede SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), as amended, and significantly strengthen the quality of auditor communications of such matters in audits of nonpublic companies. One result of this proposed standard is that the term *reportable condition* would be replaced by the term *significant deficiency*. If the standards are finalized as proposed, this would result in possible report wording changes in audits of state and local governments (for example, in

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the reporting required under *Government Auditing Standards* and Circular A-133).

### **Proposed SASs to Provide a New Framework for the Audit Process**

The Auditing Standards Board (ASB) has issued a suite of seven proposed SASs relating to the auditor's risk assessment process. The ASB believes that the requirements and guidance provided in the proposed SASs, if adopted, would result in a substantial change in audit practice and in more effective audits. The primary objective of the proposed SASs is to enhance the auditor's application of the audit risk model in practice by requiring:

- A more in-depth understanding of the entity and its environment, including its internal control, that would better enable the auditor to identify the risks of material misstatement in the financial statements and any steps the entity is taking to mitigate them.
- A more rigorous assessment of the risks of material misstatement of the financial statements based on that understanding.
- A better linkage between the assessed risks of material misstatement and the nature, timing, and extent of audit procedures performed in response to those risks.

The exposure draft consists of the following proposed SASs:

- *Amendment to Statement on Auditing Standards No. 95, Generally Accepted Auditing Standards*
- *Audit Evidence*, which will supersede SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326), as amended
- *Audit Risk and Materiality in Conducting an Audit*, which will supersede SAS No. 47, as amended, of the same title
- *Planning and Supervision*, which will supersede SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 310, "Appointment

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of the Independent Auditor”), as amended, and SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311), as amended

- *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, which together with the following proposed SAS, will supersede SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as amended
- *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, which will supersede SAS No. 45, *Omnibus Statement on Auditing Standards—1983* (AICPA, *Professional Standards*, vol. 1, AU secs. 313 and 334)
- *Amendment to Statement on Auditing Standards No. 39, Audit Sampling* (AICPA, *Professional Standards*, vol. 1, AU sec. 350)

### **Upcoming Interpretations to SAS No. 58**

The ASB is expected to soon issue interpretations to SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508), as amended, to clarify differences between a GAAS audit and an audit conducted in accordance with the standards of the PCAOB and to clarify how the auditor should report if engaged to also follow PCAOB auditing standards in the audit of a nonissuer.

### **Government Auditing Standards Developments**

Certain laws, regulations, and contracts require auditors to follow *Government Auditing Standards* (also known as the Yellow Book) promulgated by the Comptroller General of the United States. For example, some states require that local governments’ financial statements be audited in accordance with GAAS and *Government Auditing Standards*. In addition, the Single Audit Act and Circular A-133 require auditors to perform single and program-specific audits of federal awards in accordance with *Government Auditing*

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*Standards.* Further, some auditors may hold themselves out as following *Government Auditing Standards*, regardless of whether there is a requirement for the auditors to follow such standards. If you are performing engagements under *Government Auditing Standards*, you should be aware of the requirements of the 2003 *Government Auditing Standards*, which is a comprehensive revision of the 1994 version of *Government Auditing Standards* and its Amendments No. 1 through No. 3. (Note that the contents of those Amendments were incorporated into the revision.)

Issued on June 25, 2003, the 2003 *Government Auditing Standards* contains standards for financial audits, attestation engagements, and performance audits. It is effective for financial audits and attestation engagements of periods ending on or after January 1, 2004, and for performance audits beginning on or after January 1, 2004, with early application permissible. In comparison to the 1994 version, the 2003 revision reorganizes the order and presentation of the standards by function (such as planning, audit documentation, and report content) and makes various changes. Among the more significant changes, the 2003 *Government Auditing Standards*:

- Adds a new chapter on attestation engagements that includes additional fieldwork and reporting standards over and above what would be required under the AICPA's attestation standards.
- Extends to both attestation engagements and performance audits the requirements that auditors document decisions related to internal control over data significantly dependent on computerized information systems and communicate specific information to specific parties during the planning stage of the engagement or audit.
- Requires that audit and attestation staff collectively possess the technical knowledge, skills, and experience necessary to be competent for the type of work being performed before beginning the work on the assignment.
- Clarifies that the 80 hours of continuing professional education (CPE) that is required every two years for each auditor

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performing work under *Government Auditing Standards* should directly enhance the auditor's professional proficiency to perform audits or attestation engagements. The GAO is expected to review and update its existing 1991 *Interpretation of Continuing Education and Training Requirements—Government Auditing Standards* to address this clarification. In March 2004, however, the GAO posted an Internet notice on its Web site to amend paragraph 46 of the 1991 Interpretation in advance of finalizing a more comprehensive update. That notice, which auditors should review for a full understanding of its provisions, explains and provides examples of how taxation courses should support the subject matter of the *Government Auditing Standards* engagement to count towards the 80-hour requirement. It also explains how CPE that satisfies *Government Auditing Standards* requirements may or may not satisfy the CPE requirements of state licensing bodies and professional organizations (and vice versa). The notice explains and provides examples of how this change in the CPE requirements is effective beginning in 2004.

- Requires that documentation to support findings, conclusions, and recommendations be available before auditors issue their reports.
- Expands the requirements for internal quality control systems and external peer review reports. It also requires audit organizations to include the letter of comment when they provide their peer review reports to potential clients, other auditors using their work, and to the appropriate oversight bodies.
- For financial audits, including Circular A-133 audits, adds a requirement for auditors to be alert to situations or transactions that could indicate abuse, and, if indications of abuse exist that could materially affect the financial statement amounts or other financial data significant to the audit objectives, to apply procedures specifically directed to ascertain whether abuse has occurred and the effect on the financial statement amounts or other financial data.

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(*Government Auditing Standards* defines *abuse* as a situation that “involves behavior that is deficient or improper when compared with behavior that a prudent person would consider reasonable and necessary business practice given the facts and circumstances.”) Auditors should report material abuse in the auditor’s reports and communicate certain other abuse in the management letter.

For financial audits, *Government Auditing Standards* includes general standards, as well as fieldwork and reporting standards that are in addition to those required by GAAS. The following table shows the additional *Government Auditing Standards* fieldwork and reporting responsibilities specifically related to internal control; compliance with laws, regulations, and provisions of contracts or grant agreements; fraud; and abuse. The *Government Auditing Standards* general standards and other, additional fieldwork and reporting standards are in such areas as independence, competence, quality control systems, audit documentation requirements, audit follow-up, obtaining and reporting the views of responsible officials about findings and planned corrective actions, and report distribution. Auditors should refer to the 2003 *Government Auditing Standards* for a full listing and understanding of its standards.

**Additional *Government Auditing Standards* Fieldwork  
and Reporting Responsibilities Specifically Related  
to Internal Control, Compliance, Fraud, and Abuse**

***Internal Control over Financial Reporting***

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Additional Fieldwork  
Responsibilities

The auditor should communicate information regarding the nature, timing, and extent of planned testing and reporting and the level of assurance for internal control over financial reporting to certain parties during the planning stages of an audit.

The auditor also should develop additional documentation of the auditor’s consideration that the planned audit procedures are designed to achieve audit objectives when evidential matter obtained is highly dependent on computerized information systems and is material to the objective of the audit but the auditor is not relying on the effectiveness of internal control over those computerized systems that produced the information.

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Additional Reporting Responsibilities	<p>The auditor should issue a written report describing the scope of the auditor’s testing of internal control over financial reporting and presenting the results of those tests. (An opinion on internal control is not required, but is permitted if sufficient work was performed.)</p> <p>The auditor’s written report should identify deficiencies in internal control considered to be reportable conditions and those reportable conditions that are individually or in the aggregate material weaknesses. The auditor should report other deficiencies in internal control, except those that are clearly inconsequential, in a management letter.</p>
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### *Compliance*

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Additional Fieldwork Responsibilities	<p>The auditor should communicate information regarding the nature, timing, and extent of planned testing and reporting and the level of assurance on compliance with laws, regulations, and provisions of contracts or grant agreements to certain parties during the planning stages of an audit.</p> <p><i>Government Auditing Standards</i> also specifically states that the auditor should design the audit to provide reasonable assurance of detecting material misstatements resulting from noncompliance with provisions of contracts or grant agreements that have a direct and material effect on the determination of financial statement amounts or other financial data significant to the audit objectives.</p>
Additional Reporting Responsibilities	<p>The auditor should issue a written report describing the scope of the auditor’s testing of compliance with laws, regulations, and provisions of contracts or grant agreements and presenting the results of those tests. (An opinion on compliance is not required, but is permitted if sufficient work was performed.)</p> <p>The auditor’s written report should identify all illegal acts unless they are clearly inconsequential<sup>1</sup> and material violations of provisions of contracts or grant agreements. The auditor should report violations of provisions of contracts or grant agreements that are less than material but more than clearly inconsequential in a management letter.</p>

### *Fraud*

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Additional Fieldwork Responsibilities	None.
Additional Reporting Responsibilities	The auditor’s written report should identify all instances of fraud unless clearly inconsequential. <sup>1</sup>

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## *Abuse*

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Additional Fieldwork Responsibilities	The auditor has no responsibility to design the audit to detect abuse. However, the auditor should be alert to situations or transactions that could be indicative of abuse. If the auditor becomes aware of indications of abuse that could materially affect the financial statement amounts or other financial data significant to the audit objectives, the auditor should apply audit procedures specifically directed to ascertain whether abuse has occurred and the effect on the financial statement amounts or other financial data significant to the audit objectives.
Additional Reporting Responsibilities	The auditor's written report should identify all material abuse. The auditor should report abuse that is less than material but more than clearly inconsequential in a management letter.

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1. In an audit in accordance with Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (Circular A-133), the auditor should apply a financial statement materiality consideration in reporting in the *Government Auditing Standards* report fraud and illegal acts involving federal awards that are subject to Circular A-133 reporting. That is because those findings already are reported in the Circular A-133 report.
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The AICPA Audit Guide *Government Auditing Standards and Circular A-133 Audits* incorporates the provisions of the 2003 *Government Auditing Standards* for financial audits as they relate to financial statement and Circular A-133 audits. (See the discussion about the conforming changes to that Guide earlier in this section of this Alert.)

**Help Desk**—You can obtain the 2003 *Government Auditing Standards* and a summary of the significant changes it makes to the 1994 version of the standards from the GAO Web site at [www.gao.gov/govaud/ybk01.htm](http://www.gao.gov/govaud/ybk01.htm). That site includes other Yellow Book-related documents, including the CPE Interpretation and the Internet notice amending paragraph 46 of the Interpretation.

## **Independence Standards**

In a GAAS audit, auditors are required to comply with the AICPA's Code of Professional Conduct Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101). AICPA

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Ethics Interpretation 101-3, “Performance of Nonattest Services” (AICPA, *Professional Standards*, vol. 2, ET sec. 101.05), establishes requirements that members should meet to perform nonattest services for an attest client without impairing independence with regard to that client. The AICPA issued a revision of that interpretation (effective December 31, 2003) requiring that (1) the member should not perform management functions or make management decisions for the attest client, (2) the client must agree to perform certain functions in connection with the engagement to perform nonattest services, including making all management decisions, performing all management functions, and accepting responsibility for the results of the services, and (3) the member should establish and document in writing the understanding with the client about certain matters, such as the objectives of the engagement and any limitations of the engagement. The interpretation provides examples of the types of nonattest services that would be considered to impair a member’s independence. Ethics Interpretation 101-3 requires compliance with the independence regulations of authoritative regulatory bodies, including the General Accounting Office, when a member performs nonattest services for a client and is required to be independent of the client under the regulations of the applicable regulatory body.

**Help Desk**—You can find the Interpretation on the AICPA Web site at [www.aicpa.org/download/ethics/interp\\_revisions\\_Sept03.pdf](http://www.aicpa.org/download/ethics/interp_revisions_Sept03.pdf). The AICPA Web site provides a document that compares the AICPA and GAO independence rules at [www.aicpa.org/download/ethics/2004\\_02AICPA-GAO\\_rules\\_comparison.pdf](http://www.aicpa.org/download/ethics/2004_02AICPA-GAO_rules_comparison.pdf).

For audits conducted in accordance with *Government Auditing Standards*, auditors and audit organizations also are subject to the independence rules in the 2003 *Government Auditing Standards*, which arise from Amendment No. 3, *Independence*, to the 1994 *Government Auditing Standards*. Those rules, which are in some cases very similar to the AICPA independence rules and in other cases more restrictive, address when auditors and their organizations are independent from the organizations they audit by defining when personal, external, and organizational impairments to

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independence exist. Those rules first became effective for audits for periods beginning on or after January 1, 2003. (Last year's Alert provides a complete briefing on the *Government Auditing Standards* independence standards.) The GAO has issued a question and answer (Q&A) document, *Answers to Independence Standard Questions*, to address those rules. We want to draw your attention to two situations discussed in that Q&A document that you should consider before accepting certain engagements for a *Government Auditing Standards* audit client. The first concerns the implementation of GASB Statement No. 34 (see question 55) and the other concerns information technology services, such as installing or upgrading financial reporting software (see questions 68 through 74).

**Help Desk**—You can obtain the question and answer book on the *Government Auditing Standards* independence requirements from the GAO Web site at [www.gao.gov/govaud/ybk01.htm](http://www.gao.gov/govaud/ybk01.htm).

## **Other Auditing Issues**

### **SAS No. 99**

SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), contains standards and provides guidance to auditors in fulfilling their responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. (We included an extensive discussion about SAS No. 99 in last year's Alert.) We want to remind you that the AICPA Audit and Accounting Guide *State and Local Governments* includes an appendix that discusses the provisions of SAS No. 99; the AICPA Audit and Accounting Practice Aid *Fraud Detection in a GAAS Audit: Revised Edition*; and government-specific topics relating to SAS No. 99.

### **Derivative Financial Instruments**

The GASB staff issued TB 2003-1 last year to revise disclosure requirements relating to derivatives, and the GASB has an ongoing project on derivatives and hedging. (See the discussion in the

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section of this Alert titled “Accounting Issues and Developments.”) Derivative and hedging transactions, and the required reporting, can increase audit risk. We want to remind you that the AICPA provides guidance on auditing those transactions in SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1, AU sec. 332) and the Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*.

### **Commitments, Contingencies, and Subsequent Events**

Because of recent incidences of corporate fraud and the passage of the Sarbanes-Oxley Act of 2002, financial statement users are more questioning about financial condition when they read financial statements, including governmental financial statements. Disclosures about commitments, contingencies, and subsequent events help users understand an entity’s financial condition. The AICPA Audit Guide *State and Local Governments* discusses accounting standards and auditing considerations for those items, including how auditors might review the description in the government’s Management’s Discussion and Analysis (MD&A) of currently known facts, decisions, or conditions that are expected to have a significant effect on financial position or results of operations for items that represent subsequent events.

### **Financial Statement Restatements**

We have observed governments making financial statement restatements in the periods following their implementation of GASB Statements No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, and No. 34. Many of those restatements are changes in accounting principles that appear to result from increased knowledge of the provisions of the standards as preparers and auditors become more experienced with them. Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*, as amended, and GASB Statement No. 34, paragraph 17, footnote 13, provide guidance for reporting changes in accounting principles. In governmental financial statements, those changes are reported as restatements of beginning net assets/fund equity, not as a separately identified cumulative effect in the

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current-period activity statements. Auditors should consider performing procedures to support a conclusion whether a restatement and its presentation are in conformity with GAAP. Depending on the timing of the issuance of the restated financial statements, auditors also may need to take certain steps relating to prior-year financial statements as described in SAS No. 1 (AICPA, *Professional Standards*, vol. 1, AU sec. 561, “Subsequent Discovery of Facts Existing at the Date of the Auditor’s Report”), as amended.

### **Audits of Indian Tribes**

We occasionally are asked whether recognized Indian tribes are governmental entities and whether their financial statements should be prepared using governmental accounting and financial reporting guidance and audited using the provisions of the AICPA Audit and Accounting Guide *State and Local Governments*. Paragraph 1.01 of that Guide defines governmental entities, and paragraph 1.03 indicates that although some Indian tribes may not meet the definition of governmental entities, many tribes use governmental accounting and financial reporting guidance to prepare their financial statements. The financial statements of Indian tribes that meet the definition of governmental entities are subject to governmental accounting and financial reporting guidance; the financial statements of Indian tribes that are governmental entities or that otherwise use governmental accounting and financial reporting guidance should be audited using the provisions of *State and Local Governments*.

We also are occasionally asked whether Indian tribes that use governmental accounting and financial reporting guidance may omit casino operations from their financial statements. Those tribes are subject to GASB standards for the financial reporting entity and should apply GASB Statement No. 14, *The Financial Reporting Entity*, as amended, to determine whether to include casino operations in their financial statements, either as part of the primary government’s legal entity or as a component unit. If a casino operation meets the criteria for inclusion in the financial reporting entity, it should be included in the tribe’s financial statements for the auditor to consider expressing unqualified opinions on the

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opinion units that comprise the reporting entity's financial statements. If the casino operation meets the criteria for inclusion in the financial reporting entity and is not included in the financial statements, the auditor generally should consider modifying the opinions on the financial statements. The opinion units for which opinions should be modified depend on how the casino operation would have been reported if it had been included. The nature of the modification depends on the significance of omission to the affected opinion units. It is possible that the omission of a casino operation may be so significant to the financial statements that the auditor should consider expressing an adverse opinion on the financial statements taken as a whole, using the guidance in paragraph 14.10 of *State and Local Governments*. This is especially possible if the casino operation is part of the primary government's legal entity rather than a component unit. An exception to the requirement to express one or more modified opinions would involve a situation in which the casino operation is a component unit and the tribe issues financial statements that omit all component units—that is, the Indian tribe presents primary government-only financial statements. In that situation, the auditor should apply the guidance of paragraph 14.41 of *State and Local Governments*, which includes stating in the auditor's report that the primary government's financial statements do not purport to, and do not, fairly present financial position, changes in financial position, and cash flows, where applicable, of the financial reporting entity in conformity with GAAP.

We have been asked whether, for Indian tribe financial statements that omit casino operations, the auditor can express an adverse opinion on the financial statements taken as a whole and also express unqualified opinions on the other opinion units presented in the financial statements. The answer is “no.” Such a report would constitute a piecemeal opinion. SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508.64), as amended, states “Piecemeal opinions (expressions of opinion as to certain identified items in financial statements) should not be expressed when the auditor has disclaimed an opinion or has expressed an adverse opinion on the financial statements *taken as a whole* because piecemeal opinions

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tend to overshadow or contradict a disclaimer of opinion or an adverse opinion.”

### **Effect of Adopting New Accounting Standards on Auditors’ Reports**

The adoption of new accounting standards constitutes a change in accounting principle that, unless immaterial, will require the auditor’s report to include an explanatory paragraph regarding consistency. For example, a paragraph could read “As described in Note X, as of July 1, 20X4, the City has implemented a new financial reporting model as required by the provisions of GASB Statement No. 34, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments*, as amended and interpreted, and has included an additional discretely presented component unit in its financial statements as required by the provisions of GASB Statement No. 39, *Determining Whether Certain Organizations Are Component Units*.”

### **Common Engagement Deficiencies**

Following are some common deficiencies noted on governmental financial statement audits, including audits conducted in accordance with *Government Auditing Standards*, found during recent peer reviews and AICPA Professional Ethics Division investigations of CPA firms. (The AICPA Audit Risk Alert *Single Audits—2004* lists common deficiencies noted on Circular A-133 audits.) This list includes some of the same deficiencies identified in past Alerts, indicating continuing problems with the same matters. You should consider reviewing your firm’s policies and procedures to see whether your governmental engagements also might have these kinds of issues.

- The audit documentation did not evidence the required communications between predecessor and successor auditors.
- The audit organization did not submit its peer review report to the required parties.
- The engagement team did not meet the *Government Auditing Standards* or state licensing board CPE requirements.

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- The auditor used inadequate or outdated reference material related to the engagement performed.
  - The audit documentation contained inadequate or incomplete documentation regarding engagement planning.
  - The auditor did not use written audit programs or failed to tailor the audit programs for specialized industries or for specific transactions or balances (such as significant inventory and receivable balances).
  - The audit documentation did not evidence the auditor's consideration of the existence of an internal audit function or the use of service organizations.
  - The audit documentation did not evidence the auditor's reliance on the work of other auditors or of specialists.
  - The audit documentation did not evidence the auditor's consideration of the client's internal control structure, the effect of the use of information technology on internal control, or the effect of internal control on substantive procedures.
  - The auditor did not assess the level of materiality or control risk.
  - The auditor did not perform or document risk assessments for each of the five components of internal control, or at the assertion level for major account balances or transaction classes.
  - The auditor did not assess or document the risk of fraud, did not make appropriate inquiries, or did not adequately consider fraud risks in designing audit procedures.
  - The auditor did not properly apply sampling techniques.
  - The audit documentation did not include the information about samples and their selection as required by GAAS and *Government Auditing Standards*.
  - The audit documentation was generally deficient or did not include adequate information to support certain con-

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clusions, such as conclusions reached from test work on samples. In addition, for key audit areas, the auditor failed to perform adequate procedures or the audit documentation was substantially deficient. Deficiencies were specifically noted concerning procedures relating to the appropriate inclusion of component units, inventories, accounts receivable, loan covenants, the search for unrecorded liabilities and other audit cut-off procedures, subsequent events, compliance with legal and contractual provisions, and analytical procedures.

- The audit documentation did not indicate the disposition of prior audit findings and current, potential reportable conditions and other findings.
- Some audit documentation was dated after the auditor's report date.
- The auditor failed to observe the client's incorrect application of GAAP, especially the improper application of provisions of GASB Statements No. 33 and No. 34, as amended and interpreted; the improper accounting for a particular fund; or inadequate financial statement disclosure.
- The auditor did not request a legal representation letter when the client consulted an attorney.
- The auditor did not obtain a client management representation letter or did not include appropriate engagement-specific representations within the letter.
- The auditor's reports did not conform to reporting requirements. For example, the reports omitted required wording or did not appropriately address other information accompanying the basic financial statements.
- The auditor's report on the financial statements did not refer to the report required by *Government Auditing Standards* on internal control over financial reporting and on compliance (the Yellow Book report).
- The auditor did not prepare the Yellow Book report.

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- The Yellow Book report did not include or make proper reference to identified reportable conditions or reportable noncompliance.
  - The reports of other auditors relating to component units were referred to in the auditor's report on the financial statements, but not in the Yellow Book report.
  - The restricted use paragraph in the Yellow Book report failed to conform to the provisions of SAS No. 87, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 532), or was not restricted to the proper users.

### **Governmental Audit Quality Center**

In 2003, the AICPA Council authorized the establishment of the Governmental Audit Quality Center, which is being developed to provide firm members with a set of best practices and tools in the specialized area of governmental auditing, including audits performed under *Government Auditing Standards* and Circular A-133. Membership in the Center is voluntary. By becoming a member and adhering to the Center membership requirements, firms will be demonstrating their commitment to quality audit practices. Planned membership benefits include a comprehensive Web site complete with news, tools, membership interaction, and more. The Governmental Audit Quality Center is expected to start receiving firm admissions in the third quarter of 2004.

**Help Desk**—Watch the *Journal of Accountancy* and the *CPA Letter* for more details as they become available.

## **Accounting Issues and Developments**

### **GASB Pronouncements, Exposure Drafts, and Additional Projects**

#### **GASB Pronouncements on the New Financial Reporting Model**

Since 1999, the GASB has issued several pronouncements to develop a new financial reporting model for state and local governments. The “core” reporting model standard, GASB Statement

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No. 34, requires both government-wide and fund financial statements. The other reporting model standards are GASB Statements No. 35, *Basic Financial Statements—and Management’s Discussion and Analysis—for Public Colleges and Universities*; No. 37, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments: Omnibus*; No. 38, *Certain Financial Statement Note Disclosures*; and No. 41, *Budgetary Comparison Schedules—Perspective Differences*; and GASB Interpretation No. 6, *Recognition and Measurement of Certain Liabilities and Expenditures in Governmental Fund Financial Statements*.

The reporting model standards became effective in three phases starting with 2002 financial statements. The third and final phase of implementation—for small governments—starts with 2004 financial statements for governments with fiscal year ends after June 15. (A “phase 3” government with an earlier year end, for example, May 31, is not required to implement until its 2005 financial statements.) (The 2002 and 2003 Alerts provide thorough briefings on the reporting model standards, including their effective dates.) You should review the original pronouncements for a complete understanding of their provisions. The GASB staff also provides questions and answers about the reporting model and other standards in its *Comprehensive Implementation Guide* (GASB Q&A), which is updated annually.

**Help Desk**—The AICPA continues to make available its Audit and Accounting Practice Aid *Understanding and Implementing GASB’s New Financial Reporting Model: A Question and Answer Guide for Preparers and Auditors of State and Local Governmental Financial Statements, Revised Edition* (product no. 022516kk). This Practice Aid will help you and the governments you audit understand the new standards. In addition, the GASB Web site contains a GASB Statement No. 34 page at [www.gasb.org/repmodel/index.html](http://www.gasb.org/repmodel/index.html).

### **GASB Statement No. 39**

In May 2002, the GASB issued Statement No. 39, *Determining Whether Certain Organizations Are Component Units*. The Statement is effective for financial statements for periods beginning

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after June 15, 2003, with earlier application encouraged. GASB Statement No. 39, which amends GASB Statement No. 14, *The Financial Reporting Entity*, provides guidance to determine whether certain organizations for which a primary government is not financially accountable should be reported as component units based on the nature and significance of their relationship with the primary government. Generally, GASB Statement No. 39 requires that reporting entity financial statements include as discretely presented component units certain legally separate, tax-exempt organizations that raise or hold economic resources for the government, its component units, or its constituents—such as fund raising foundations. (The 2002 Alert provides a thorough briefing on GASB Statement No. 39, and the 2003 Alert discusses a potential practice problem with the Statement’s “significance” criterion.)

Preparers and auditors have expressed concern about a primary government’s ability to obtain timely financial information from the legally separate organizations that GASB Statement No. 39 requires be included in reporting entity financial statements. That concern is similar to the concern expressed when GASB Statement No. 14 was implemented in the early 1990s. Auditors should consider encouraging primary government officials to work with officials from those separate organizations to help them understand the need for the information. Preparers and auditors also have expressed concern that those organizations often do not have financial statement audits. It may be necessary for primary government officials to work with those organizations to arrange for audits. If the component unit’s financial statements are not included in the reporting entity’s financial statements or are included but not audited, the auditor should discuss with the primary government the potential effect on the auditor’s report on the reporting entity’s financial statements. It is possible that the primary government may want to expand the scope of the audit engagement on the reporting entity’s financial statements to include the component units’ financial statements.

Another concern that preparers and auditors express about implementing GASB Statement No. 39 is that the newly included

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component units generally report using a different GAAP reporting model than do their primary governments. Item 4.100 in the GASB Q&A discusses how a reporting entity might display the financial statements of a component unit that uses a GAAP reporting model other than the governmental model. Among the alternatives is to present the change statement of a component unit that does not present a statement of activities on a separate page. Further, the nonauthoritative Appendix E in GASB Statement No. 39 illustrates how information presented in a non-governmental format can be presented so that it is “compatible” with the primary government’s financial statement formats.

### **GASB Statement No. 40**

In March 2003, the GASB issued its Statement No. 40, *Deposit and Investment Risk Disclosures, an amendment of GASB Statement No. 3*. The Statement requires specific disclosures for credit risk, concentration of credit risk, interest rate risk, and foreign currency risk. It also modifies GASB Statement No. 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements*. One of those modifications limits the required disclosure of custodial credit risk to “category 3” deposits and investments. GASB Statement No. 40 is effective for financial statements for periods beginning after June 15, 2004, with earlier application encouraged. Because of the potential complexity of certain governments’ investment portfolios and operations, you should consider alerting your clients to the need to allow sufficient time to adopt appropriate reporting processes for GASB Statement No. 40.

### **GASB Statement No. 41**

Issued in May 2003, GASB Statement No. 41, *Budgetary Comparison Schedules—Perspective Differences*, clarifies the requirements in GASB Statement No. 34 for reporting budgetary comparison information. The Statement applies to governments with budgetary structures (certain program-based budgets, for example) that prevent them from presenting budgetary comparison information for their general and major special revenue funds, as required by GASB Statement No. 34. GASB Statement

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No. 41 requires those governments to present budgetary comparison schedules as RSI based on the fund, organization, or program structure that it uses for its legally adopted budgets. Those presentations may not be displayed as basic financial statements. GASB Statement No. 41 is effective simultaneously with GASB Statement No. 34. (For governments that already had implemented GASB Statement No. 34 when GASB Statement No. 41 was issued, the Statement was effective for periods beginning after June 15, 2002.)

### **GASB Statement No. 42**

In November 2003, the GASB issued its Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*. The Statement requires governments to measure, recognize, and disclose the effects of capital asset impairment in their financial statements when it occurs. It also clarifies and establishes accounting requirements for insurance recoveries, including those associated with capital asset impairment. GASB Statement No. 42 is effective for financial statements for periods beginning after December 15, 2004, with earlier application encouraged.

As provided in GASB Statement No. 42, governments should perform an assessment of impairment when certain events of changes in circumstances affecting capital assets are present. For example, one common indicator of capital asset impairment is the enactment or approval (not the effective date) of laws or regulations, such as new water quality standards that a water treatment plant does not and cannot be modified to meet. Governments are not required to perform additional procedures to identify potential impairments beyond those performed as part of their normal operations. However, the financial statement preparers within an organization may need to develop a process to alert them to indicators of impairment known by others within that organization, such as operational managers. You should consider alerting your governmental clients to the need to allow sufficient time to adopt appropriate internal control processes for this provision.

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## GASB Statement No. 43

In April 2004, the GASB issued its Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*. This Statement establishes accounting and financial reporting standards for plans that provide postemployment benefits other than pension benefits (known as other postemployment benefits or OPEB). As defined in GASB Statement No. 43, OPEB are (1) postemployment healthcare benefits and (2) other types of postemployment benefits (for example, life insurance) if provided separately from a pension plan. The provisions of the Statement apply if the OPEB plan is reported in the financial statements of a participating employer, plan sponsor, public employee retirement system (PERS), or other entity that administers the plan. GASB Statement No. 43 supersedes GASB Statement No. 26, *Financial Reporting for Postemployment Healthcare Plans Administered by Defined Benefit Pension Plans*, and amends various other GAAP requirements relating to the financial reporting for OPEB plans. The provisions of GASB Statement No. 43 are effective in three phases based on the GASB 34 implementation phase of the employer (for single-employer plans) or of the largest participating employer in the plan (for multiple-employer plans). Specifically:

<i>If the sole or largest participating employer's GASB Statement No. 34 phase was</i>	<i>The plan should apply GASB Statement No. 43 for periods beginning after</i>
Phase 1	December 15, 2005
Phase 2	December 15, 2006
Phase 3	December 15, 2007

Early implementation of GASB Statement No. 43 is encouraged. The GASB plans to issue a related Statement, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, which would establish standards for accounting and financial reporting of OPEB costs and obligations by state and local governmental employers that offer OPEB and by plan sponsors. (See the following discussion on GASB Exposure Drafts.)

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## GASB Technical Bulletin

In April 2004, the GASB staff issued GASB TB 2004-1, *Tobacco Settlement Recognition and Financial Reporting Entity Issues*, to address accounting by state and certain local governments, referred to as *settling governments*, for transactions relating to the multi-state tobacco settlement. Some settling governments have created a legally separate entity, referred to in the TB as *Tobacco Settlement Authorities* (TSAs), which generally should be reported as a blended component unit of the settling government that created it. GASB TB 2004-1 also addresses how settling governments and TSAs should recognize assets and revenue for tobacco settlement resources—payments that result from exchange transactions—and the resource flows that result from the issuance of tobacco settlement revenue bonds. The provisions of the TB are effective for financial statements for periods ending after June 15, 2004, with earlier application encouraged.

## GASB Exposure Drafts

The GASB has outstanding exposure drafts (EDs) of two proposed Statements that it plans to finalize soon:

- *Economic Condition Reporting: The Statistical Section*. This ED proposes to amend existing guidance for the presentation of information in a statistical section that accompanies a government's basic financial statements. Its proposed effective date is for statistical sections prepared for periods beginning after June 15, 2005, with earlier application encouraged.
- *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. This revised ED proposes standards for how employers and plan sponsors should report costs and obligations for OPEB. The Statement would become effective in three annual phases based on a government's implementation phase for the purpose of GASB Statement No. 34 starting for periods beginning after December 15, 2006. Earlier application would be encouraged.

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## Special Report

In August 2003, the GASB released a special report, *Reporting Performance Information: Suggested Criteria for Effective Communication*, which describes criteria that state and local governments can use in preparing external reports on performance information, which also is referred to as *service efforts and accomplishments*. Over the next few years, the GASB plans to actively encourage and assist with experiments in such reporting using those suggested criteria.

**Help Desk**—The special report is available on the GASB's Performance Measurement for Government Web site at [www.seagov.org](http://www.seagov.org). You also can call (800) 748-0659 and ask for product code GRPI.

## Additional GASB Projects

GASB projects that may see documents relating to proposed accounting and financial reporting standards (generally EDs) released in the remainder of 2004 and in 2005 include (1) derivatives and hedging, (2) pollution remediation obligations, (3) securitizations and other transfers, and (4) net assets/fund balance. Also expect an ED of a proposed TB on termination offers and benefits, an ED of a proposed Concepts Statement to define methods of communicating financial and finance-related information and criteria for using each method, and implementation guides on OPEB and statistical sections.

The GASB has identified several financial reporting issues as potential longer-term projects: (1) additional economic condition reporting issues, (2) fiduciary responsibilities, (3) service efforts and accomplishments (performance measurement), (4) the preservation method for infrastructure assets, (5) electronic financial reporting, (6) intangible assets, (7) government combinations, (8) exchange-like revenues, (9) in-kind contributions, and (10) loan versus grant classification.

**Help Desk**—To track the progress of the GASB's projects, go to the GASB Web site at [www.gasb.org](http://www.gasb.org). The GASB generally posts EDs on that site during the exposure period.

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## Other Accounting Issues

### Accounting and Financial Reporting Uncertainties

We continue to hear about certain common uncertainties in governmental accounting and financial reporting, especially concerning GASB Statement No. 34 and its related pronouncements. The following list includes some accounting and financial reporting requirements that are posing difficulties. See also the similar listing in last year's Alert as well as the material about financial statement restatements and audits of Indian tribes in the section of this Alert titled "Audit and Attestation Issues and Developments."

- The MD&A should include reasons for significant changes in financial statement amounts from the prior year, not simply the amounts or percentages of change. (GASB Statement No. 34, paragraph 11c)
- If the government presents two-year comparative financial statements (that is, a complete prior-period presentation at the level of detail required by GAAP), the MD&A should address both years presented. That is, the MD&A should discuss both (1) the current-year results in comparison with the prior year and (2) the prior-year results in comparison with the second prior year. (GASB Q&A, item 7.14)
- If the government presents only current-year financial statements, the MD&A should discuss the current-year results in comparison with the prior year, with emphasis on the current year. That is, the MD&A should not discuss only the current-year results. (GASB Statement No. 34, paragraph 9)
- The statement of activities should classify revenue from fines as program revenue, specifically as charges for services or a subheading thereof. (GASB Statement No. 34, paragraph 49, as superseded by GASB Statement No. 37, paragraph 13; GASB Q&A, item 7.179)

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- The statement of activities should classify sales taxes shared with the government by other governments as grants and contributions. The statement should not classify the shared revenue as sales tax revenue because the government receiving the shared revenue does not impose or levy the taxes. (GASB Q&A, item 7.191)
  - The statement of activities should classify revenues from operating and capital special assessments as program revenue, not as general revenue. (GASB Q&A, items 7.199 and 7.200)
  - The statement of activities should classify special and extraordinary items separately from general revenue by alignment, labeling, or other means. (GASB Statement No. 34, paragraphs 38 and 54)
  - Governments should capitalize land, land improvements, rights of way, and easements associated with infrastructure assets. (GASB Statement No. 34, paragraph 18, as amended, and various items in the GASB Q&A, including items 7.50, 7.56, 7.418, and 7.423)
  - A government's retroactive capitalization of infrastructure should consider not only the infrastructure for which the government previously recorded expenditures, but also contributed infrastructure (such as from developer contributions). (GASB Statement No. 34, paragraph 148, and various items in the GASB Q&A, including items 7.55, and 7.56)
  - The government-wide and fund financial statements should report transfers between the primary government and its discretely presented component units as if they were external transactions—that is, as revenues and expenditures/expenses. (GASB Statement No. 34, paragraph 61)
  - Governments should recognize revenue from nonexchange impact or property development fees based on the provisions of GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*. They generally

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should not defer the recognition of that revenue until it is spent.

- The compensated absences liability reported in the governmental fund financial statements should be that portion of the total compensated absences liability that “normally would be liquidated with expendable available financial resources” and, absent unusual circumstances, that amount should differ from the amount of the governmental activities compensated absences liability disclosed as due within one year. In the governmental fund financial statements, the compensated absences liability should be recognized as payments come due each period based on relevant events, such as employee resignations and retirements. The portion of the governmental activities compensated absences liability disclosed as due within one year should be based on payments expected in the following year for resignations, retirements, and paid absences. (GASB Interpretation No. 6, paragraph 14; GASB Statement No. 34, paragraph 119c; and GASB Q&A, item 7.119)
- The disclosure of the change in the compensated absences liability should separately display amounts earned and used, and not net the two amounts. (GASB Statement No. 34, paragraph 119b)
- The summary reconciliations from the fund financial statements to the government-wide financial statements should include appropriate explanations on the face of the reconciliation or in the notes to the financial statements. (GASB Statement No. 34, paragraph 77)
- The government-wide statement of net assets should report net assets as restricted when constraints placed on the use of net assets are either (1) externally imposed by creditors, grantors, contributors, or laws or regulations of other governments, or (2) imposed by law through constitutional provisions or enabling legislation. (GASB Statement No. 34, paragraph 34)

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- If the government presents two-year comparative financial statements, the required disclosures of changes in capital assets and long-term debt should address both years presented. (AICPA *Technical Practice Aids*, vol. 1, sec. 1100.07).

### **Voluntary Interim Disclosure**

A group of organizations representing the interests of those who prepare, audit, and use governmental financial reports has been working on a “template” for a minimum level of voluntary, public disclosure of interim financial information. Tentatively the disclosures involve certain budget-to-actual information, certain cash receipts and disbursements information, balances and changes in long- and short-term debt, and significant events. Such information would be made available on an individual government’s Web site. A pilot project is currently underway. The groups involved in this effort are not recommending or suggesting auditor involvement with the disclosure of interim financial information.

**Help Desk**—To see the full interim financial disclosure proposal, go to [www.nasact.org/techupdates/issues.cfm](http://www.nasact.org/techupdates/issues.cfm).

## **References for Additional Guidance**

### **American Institute of Certified Public Accountants**

#### **Web Site**

AICPA Online ([www.aicpa.org](http://www.aicpa.org)) is the AICPA’s Web site on the Internet. The site offers users the opportunity to stay abreast of developments in accounting, auditing, and professional ethics. Online resources include professional news, membership information, state and federal legislative updates, AICPA press releases, speeches, exposure drafts, and a list of links to other accounting- and finance-related sites. The AICPA Web site also features a “Talk to Us” section, allowing users to send e-mail messages directly to AICPA representatives or teams.

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## Publications

The following AICPA publications may be of interest to auditors of state and local governments:

- Audit and Accounting Guide *Audits of State and Local Governmental Units (Non-GASB 34 Edition)* (product no. 012563kk) (The AICPA is no longer updating this edition of the Guide, although it will make electronic and printed copies available for a limited time.)
- Audit and Accounting Guide *State and Local Governments* (product no. 012664kk) (This is the 2004 edition of the GASB 34 Guide.)
- Audit and Accounting Guide *Health Care Organizations* (product no. 012614kk)
- Audit and Accounting Guide *Property and Liability Insurance Companies* (product no. 012674kk)
- Audit Guide *Government Auditing Standards and Circular A-133 Audits* (product no. 012744kk) (This is the 2004 edition of the Audit Guide previously titled *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*.)
- SOP 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising* (product no. 014887kk)—This SOP is an appendix to the two Audit and Accounting Guides for state and local governments (see previous bullets) and the Audit and Accounting Guide *Not-for-Profit Organizations* (product no. 012644kk). The SOP also is included in *AICPA Technical Practice Aids* (product no. 005142kk).
- *Applying OCBOA in State and Local Governmental Financial Statements* (product no. 003314kk) **NEW**—This nonauthoritative Audit and Accounting Practice Aid provides guidance in preparing OCBOA financial statements

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for state and local governments and for the appropriate auditor reporting on those financial statements.

- *Audit and Accounting Manual* (product no. 005133kk)—Updated annually, this publication has a section of audit programs for audits in accordance with *Government Auditing Standards* and the Single Audit Act Amendments of 1996.
- *Auditing Governmental Financial Statements: Programs and Other Practice Aids* (product no. 006602kk) **NEW**—This nonauthoritative companion to *State and Local Governments* primarily comprises illustrative audit programs and other practice aids—such as an engagement letter, a management representation letter, and deposit and investment confirmations. An accompanying CD-ROM has an electronic version of each practice aid and of a case study on selecting, evaluating the results of, and reporting on opinion units that could be used as a staff training tool.
- *Checklists and Illustrative Financial Statements for State and Local Governments* (product no. 009034kk)—Updated annually, this publication provides checklists and illustrations of financial statements, note disclosures, and auditors' reports, including reports in accordance with *Government Auditing Standards* and the Single Audit Act Amendments of 1996.
- *Understanding and Implementing GASB's New Financial Reporting Model: A Question and Answer Guide for Preparers and Auditors of State and Local Governmental Financial Statements, Revised Edition* (product no. 022516kk)—This Audit and Accounting Practice Aid provides a summary of the significant portions of GASB Statement No. 34 and related GASB publications in a question-and-answer format.

### **Continuing Professional Education Courses**

The AICPA offers continuing professional education (CPE) in the form of both group-study and self-study courses, and in print and video format.

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Group-study courses include the following:

- Advanced Auditing of HUD-Assisted Projects
- Applying A-133 to Nonprofit and Governmental Organizations
- Audits of HUD-Assisted Projects
- Clever Cases on Current Complexities Confronting Governments and Not-for-Profits
- Extra-Strength GASB No. 34
- Foundations in Governmental Accounting: In GASB We Trust
- Fraud in the Governmental and Not-for-Profit Environments: What a Steal!
- GASB No. 34 Auditing: The Home of the Brave
- GASB No. 34 Implementation: From Here to There
- GASB No. 34 Infrastructure and Capital Assets: How in the GASB Are We Going to Do This?
- Governmental Accounting and Auditing Update
- Governmental and Nonprofit Annual Update
- Solving Complex Single Audit Issues for Government and Nonprofit Organizations
- Workpaper Techniques for Government and Nonprofit Organizations
- The Revised Yellow Book: *Government Auditing Standards*

Self-study courses include the following:

- Advanced Auditing of HUD-Assisted Projects (product no. 730190kk)
- Applying A-133 to Nonprofit and Governmental Organizations (product no. 730200kk)
- Audits of HUD-Assisted Projects (product no. 730295kk)

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- Clever Cases on Current Complexities Confronting Governments and Not-for-Profits (product number 731910kk) **NEW**
  - Extra-Strength GASB No. 34 (product no. 731761kk)
  - Foundations in Governmental Accounting: In GASB We Trust (product no. 731641kk)
  - Fraud in the Governmental and Not-for-Profit Environments: What a Steal! (product number 731920kk) **NEW**
  - GASB No. 34 Auditing: The Home of the Brave (product no. 731332kk)
  - GASB No. 34 Implementation: From Here to There (product no. 731569kk)
  - GASB No. 34 Infrastructure and Capital Assets: How in the GASB Are We Going to Do This? (product no. 731564kk)
  - Governmental Accounting and Auditing Update (product no. 736474kk)
  - Governmental and Nonprofit Annual Update (product number 731930kk) **NEW**
  - Solving Complex Single Audit Issues for Government and Nonprofit Organizations (product no. 734408kk)
  - Workpaper Techniques for Government and Nonprofit Organizations (product no. 732633kk)
  - The Revised Yellow Book: *Government Auditing Standards* (product no. 736113kk)

The AICPA also offers the following video courses:

- GASB No. 34 Auditing: The Home of the Brave (product no. 197112kk)
- Governmental Accounting and Auditing Update (product no. 186478kk)

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- The Revised Yellow Book: *Government Auditing Standards* (product no. 187103kk)
  - Applying A-133 to Nonprofit and Governmental Organizations (product no. 187202kk)

### **Online CPE**

AICPA InfoBytes, offered exclusively through CPA2Biz.com, is AICPA's flagship online learning product. Divided into 1- and 2-credit courses that are available 24/7, AICPA InfoBytes offers hundreds of hours of learning in a wide variety of topics. Governmental topics include the Yellow Book, Circular A-133 auditing, GASB Statement No. 34, HUD, industry updates, and other pertinent issues. To register or learn more, visit [www.cpa2biz.com/infobytes](http://www.cpa2biz.com/infobytes).

### **Industry Conference and Training Program**

The AICPA will hold its 21st annual National Governmental Accounting and Auditing Update Conference on August 23-24, 2004, in Washington, DC, and again on September 27-28, 2004, in Broomfield, Colorado. The conference is designed for practitioners; officials working in federal, state, or local governmental finance and accounting; and recipients of federal awards. It is the premier forum for the discussion of important governmental accounting and auditing developments. Participants will receive updates on current issues, practical advice, and timely guidance on recent developments from experts.

The AICPA also offers an annual training program called the National Governmental and Not-for-Profit Training Program. This year's program will be held on October 23-25, 2004, in Las Vegas, NV. The program is designed for practitioners or accountants, auditors, and other staff in government who want in-depth, hands-on training in government accounting and auditing.

For more information about the conference or the training program, please contact AICPA's Service Center Operations at (888) 777-7077 or at [www.cpa2biz.com](http://www.cpa2biz.com).

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## **Accounting and Auditing Technical Hotline**

The Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077 or go to the AICPA's Web site at [www.aicpa.org](http://www.aicpa.org).

## **Ethics Hotline**

Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. Call (888) 777-7077.

## **Fax Hotline**

The AICPA has a 24-hour fax system that enables interested persons to obtain information that includes, for example, current AICPA comment letters, conference brochures and registration forms, CPE information, actions of the Accounting Standards Executive Committee (AcSEC), and legislative news. To access the hotline, dial (201) 938-3787 from a fax machine and follow the voice cues.

## **Service Center Operations**

To order AICPA products, receive information about AICPA activities, and find help on your membership questions call the AICPA Service Center Operations at (888) 777-7077. The best times to call are 8:30 a.m. to 11:30 a.m. and 2:00 p.m. to 7:30 p.m., Eastern Standard Time. You also can order AICPA products from the Service Center by facsimile at (800) 362-5066 or visit [www.cpa2biz.com](http://www.cpa2biz.com) to obtain product information and place on-line orders.

## **AICPA's Antifraud and Corporate Responsibility Resource Center**

The AICPA's Antifraud and Corporate Responsibility Resource Center ([www.aicpa.org/antifraud](http://www.aicpa.org/antifraud)) allows you to select optional ways to learn about fraud. The Center spotlights the new Web-based fraud and ethics case studies and commentaries recently issued, the AICPA antifraud Web cast series, the interactive CPE

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course *Fraud and the CPA*, and a competency model that allows you to assess your overall skills and proficiencies as they relate to fraud prevention, detection, and investigation, among other topics. In addition, the site offers press releases and newsworthy items on other AICPA courses related to fraud prevention and detection, and an overview of the AICPA Antifraud and Corporate Responsibility Program.

## **Governmental Accounting Standards Board**

GASB publications can be obtained by calling the GASB Order Department at (800) 748-0659. Publications are also available by mail (P.O. Box 30784, Hartford, CT 06150) or on the GASB's Web site at [www.gasb.org](http://www.gasb.org).

The GASB offers the following publications and services:

- *Codification of Governmental Accounting and Financial Reporting Standards*. The 2004–2005 edition is as of June 30, 2004, and will be available in the fall of 2004.
- *GASB Original Pronouncements*. The 2004–2005 edition is as of June 30, 2004, and will be available in the fall of 2004.
- GASB staff document *Comprehensive Implementation Guide—2004*. This document, issued once a year, includes all separately issued implementation guides in one publication. This Guide provides, in a question-and-answer format, relevant and helpful implementation guidance on various GASB standards.
- *GASB Governmental Accounting Research System (GARS)*. GARS, which is an electronic version of the GASB's *Codification of Governmental Accounting and Financial Reporting Standards*, *Original Pronouncements*, and *Implementation Guides*, is updated twice a year.
- *GASB User Guides*. The GASB has published a series of nonauthoritative guides to assist different users of government financial statements to understand what information can be found in financial statements prepared using the provisions of GASB Statement No. 34.

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- *GASB Web site.* Information about the GASB can be found on its Web site, [www.gasb.org](http://www.gasb.org). The site links to online resources about GASB Statement No. 34. The “What’s New?” section contains the latest news about the GASB and governmental accounting, as well as calendars of GASB meetings, speaking engagements, constituent events, outstanding due process documents, the current-period technical plan, and other frequently requested materials. Other items include “Facts about GASB”; summaries of all final GASB documents and ordering information; a list of board members, staff, and advisory council members with their e-mail addresses; and a technical inquiry system.
  - *Performance Measurement for Government Web site.* The GASB’s second Web site, located at [www.seagov.org](http://www.seagov.org), is a clearinghouse for information about the development, use, and reporting of performance measures for governments. The site’s main features include a citizens’ guide and links to government performance indicators, studies, reports, government sites, ongoing projects, and several online discussion groups.
  - *Fax Information System.* The GASB has a 24-hour fax system that enables interested persons to obtain information on upcoming meetings, the current-period technical plan, and “Facts about GASB.” To access the system, dial (203) 847-0700, ext. 14, from a fax machine, and follow the voice cues.

## **General Accounting Office**

The GAO Web site at [www.gao.gov](http://www.gao.gov) contains links to the hundreds of reports and testimony to the Congress each year on a variety of subjects, including accounting, budgeting, and financial management. Hard copies of GAO reports and testimony can be obtained from the GAO, 441 G St NW, Room LM, Washington, DC 20548; phone (202) 512-6000; fax (202) 512-6061; or [www.gao.gov/cgi-bin/ordtab.pl](http://www.gao.gov/cgi-bin/ordtab.pl).

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The GAO's Web site also includes Comptroller General decisions and legal opinions, GAO policy documents, and special publications. You may subscribe to GAO daily electronic alerts at [www.gao.gov/subtest/subscribe.html](http://www.gao.gov/subtest/subscribe.html).

The following publications are available on the GAO's Web site at [www.gao.gov/govaud/ybk01.htm](http://www.gao.gov/govaud/ybk01.htm) and through the Superintendent of Documents, U.S. Government Printing Office (GPO), P.O. Box 371954, Pittsburgh, PA 15250-7954; phone (866) 512-1800 or (202) 512-1800; fax (202) 512-2250; or [bookstore.gpo.gov/index.html](http://bookstore.gpo.gov/index.html).

- *2003 Government Auditing Standards*—These standards relate to financial and performance audits and attestation engagements of governmental organizations, programs, activities, and functions, and of governmental funds received by contractors, nonprofit organizations, and other nongovernmental organizations. The 2003 *Government Auditing Standards* is a comprehensive revision of the 1994 version of *Government Auditing Standards* and its Amendments No. 1 through No. 3. (Note that the contents of those Amendments were incorporated into the revision.)
- *Government Auditing Standards: Answers to Independence Questions* responds to questions related to *Government Auditing Standards* independence requirements, including implementation time frame, underlying concepts, and application in specific nonaudit circumstances.
- *Interpretation of Continuing Education and Training Requirements*—*Government Auditing Standards* establishes specific CPE requirements for auditors working on audits performed in accordance with those standards. This 1991 Interpretation guides audit organizations and individual auditors on implementing the CPE requirements by answering the most frequently asked questions from the audit community. As noted in the section of this Alert entitled "*Government Auditing Standards* Developments," the GAO is expected to soon revise this Interpretation and has issued an Internet notice to amend paragraph 46 of the Interpretation.

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## Government Finance Officers Association

The Government Finance Officers Association (GFOA) can be contacted at 203 North LaSalle Street, Suite 2700, Chicago, IL 60601-1210; phone (312) 977-9700; fax (312) 977-4806; [www.gfoa.org](http://www.gfoa.org). Its publications include:

- *Governmental Accounting, Auditing and Financial Reporting: Using the GASB 34 Model*—This publication, commonly known as the GAAFR or “Blue Book,” provides detailed professional guidance on the practical application of the new financial reporting model to state and local governments. The basic text of the GAAFR also is available on CD-ROM. The accompanying *GAAFR Update Supplement* amends the text to incorporate subsequent developments. (*The GAAFR Study Guide Outlines and Exercises* and *The GAAFR Self-Study Course* also are available to assist those wishing to use the GAAFR for instructional or self-study purposes.)
- *General-Purpose Government Checklist for the Certificate of Achievement for Excellence in Financial Reporting Program*—This detailed checklist has been completely revised to reflect GASB Statement No. 34 and is available free of charge on the GFOA Web site.
- *Model Request for Proposal for Auditing Services (diskette)*—This diskette includes a model request for proposals for auditing services in WordPerfect 6.1 format (recently updated).
- *Evaluating Internal Controls: A Local Government Manager’s Guide*—This publication is designed for public managers seeking the practical guidance needed to assume a leadership role in the design, implementation, and maintenance of a comprehensive framework of internal control.
- *Accounting Issues and Practices: A Guide for Smaller Governments*—This 12-chapter manual provides “how to” advice on the basic duties of local government finance officials. Sample documents are included throughout.

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- *A Guide to Arbitrage Requirements for Governmental Bond Issues and 1994 Supplement*—These two publications present a comprehensive overview of federal arbitrage requirements.
  - *Pension Accounting and Reporting; Pension CAFRs: Guidelines for the Preparation of a Public Employee Retirement System Comprehensive Annual Financial Report; 2000 Survey of State and Local Government Employee Retirement Systems—Survey Report*; and the PENDAT 2000 Database and *User’s Manual*—Various publications and other products on the administration of and financial reporting for public employee retirement systems (PERSs).
  - *GAAFR Review*—This eight-page subscription newsletter, issued 10 times each year, covers major issues in governmental accounting, auditing, and financial reporting and includes analyses of recent authoritative pronouncements.
  - *Recommended Practices for State and Local Governments*—The GFOA’s recommended practices identify “best practices” in each of the major disciplines of state and local government finance. They are available free of charge on the GFOA Web site.
  - *Financial Indicators Data Base*—The GFOA makes available each year key data extracted from comprehensive annual financial reports (CAFRs) submitted to its certificate program. Separate data bases are available for counties, general-purpose governments, and school districts.

The GFOA also publishes an “elected officials” series, which consists of *An Elected Official’s Guide to the New Governmental Financial Reporting Model*, *An Elected Official’s Guide to Fund Balance*, *An Elected Official’s Guide to Auditing*, and *An Elected Official’s Guide to Internal Controls and Fraud Prevention*.

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This Audit Risk Alert replaces *State and Local Governmental Developments—2003*.

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The *State and Local Governmental Developments* Audit Risk Alert is published annually. As you encounter audit and industry issues that you believe warrant discussion in next year's Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert would also be greatly appreciated. You may e-mail these comments to [rrampulla@aicpa.org](mailto:rrampulla@aicpa.org) or write to:

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AICPA  
Harborside Financial Center  
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Jersey City, NJ 07311-3881

We also suggest that you review the annual AICPA Audit Risk Alert *Single Audits—2004 (Audits of Organizations Receiving Federal Awards: Single Audits Performed in Accordance With Office of Management and Budget Circular A-133)* if you have clients that receive federal money. That Alert addresses current issues of relevance to the performance of single audits, including regulatory, legislative, and other developments, among its many topics. Also review the AICPA *Audit Risk Alert—2003/04*, which is a general update on economic, auditing, accounting, and other professional developments. That publication discusses numerous general audit topics of interest that, although not specifically geared toward an audit of the financial statements of state and local governments, might be relevant to auditors of those financial statements.



## ***The Internet—An Auditor’s Research Tool***

If used properly, the Internet can be a valuable tool for auditors. Through the Internet, auditors can access a wide variety of global business information. For example, information is available relating to professional news, state CPA society information, IRS activities, software downloads, university research materials, currency exchange rates, stock prices, annual reports, and legislative and regulatory initiatives. Not only are they accessible from the computer, but they are also available at any time, often free of charge.

A number of resources provide direct information, whereas others may simply point to information inside and outside of the Internet. Auditors can use the Internet to:

- Obtain audit and accounting research information
- Obtain information, regulations, and documents from federal agencies and departments
- Discuss audit issues with peers
- Communicate with audit clients
- Obtain information from a client’s Web site
- Obtain information from professional associations

There are caveats to keep in mind when using the Internet. Reliability varies considerably. Some information on the Internet has not been reviewed or checked for accuracy; we advise caution when you access data from unknown or questionable sources. Although a vast amount of information is available on the Internet, much of it may be of little or no value to auditors. Accordingly, auditors should learn how to use search engines effectively and efficiently. The Internet is best used in tandem with other research

tools, because it is unlikely that all desired research can be conducted solely from Internet sources.

The following table lists Web sites of many of the organizations referred to in this Audit Risk Alert, as well as others that auditors of state and local governments may find useful. Those auditors also should refer to the Audit Risk Alert *Single Audits—2004* for a listing of Web sites of various federal agencies and related organizations.

<i>Organization</i>	<i>Web Site Address</i>
American Institute of CPAs	<a href="http://www.aicpa.org">www.aicpa.org</a>
Association of Government Accountants	<a href="http://www.agacgfm.org">www.agacgfm.org</a>
Financial Accounting Standards Board	<a href="http://www.fasb.org">www.fasb.org</a>
General Accounting Office:	
Main page	<a href="http://www.gao.gov">www.gao.gov</a>
Government Auditing Standards section	<a href="http://www.gao.gov/govaud/ybk01.htm">www.gao.gov/govaud/ybk01.htm</a>
General Printing Office Access (with links to search Code of Federal Regulations, <i>Federal Register</i> , and Public Laws)	<a href="http://www.access.gpo.gov">www.access.gpo.gov</a>
Government Finance Officers Association	<a href="http://www.gfoa.org">www.gfoa.org</a>
Governmental Accounting Standards Board:	
Main page	<a href="http://www.gasb.org">www.gasb.org</a>
Performance Measurement for Government	<a href="http://www.seagov.org">www.seagov.org</a>
U.S. House of Representatives	<a href="http://www.house.gov">www.house.gov</a>
Internal Revenue Service	<a href="http://www.irs.gov">www.irs.gov</a>
Library of Congress	<a href="http://loc.gov">loc.gov</a>
Municipal Securities Rulemaking Board	<a href="http://www.msrb.org">www.msrb.org</a>
National Association of Local Government Auditors	<a href="http://www.nalga.org">www.nalga.org</a>
National Association of State Auditors, Comptrollers, and Treasurers	<a href="http://www.nasact.org">www.nasact.org</a>
Public Company Accounting Oversight Board	<a href="http://www.pcaobus.org">www.pcaobus.org</a>
Securities and Exchange Commission	<a href="http://www.sec.gov">www.sec.gov</a>
U.S. Senate	<a href="http://www.senate.gov">www.senate.gov</a>
Thomas Legislative Search	<a href="http://thomas.loc.gov">thomas.loc.gov</a>



